S. HRG. 98-128

PAYMENT-IN-KIND TAX LEGISLATION

HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

AND

SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION
ON

S. 446, S. 495 and S. 527

February 28, 1983

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PAYMENT-IN-KIND TAX LEGISLATION

MONDAY, FEBRUARY 28, 1983

U.S. SENATE, SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION, SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE, COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittees met, pursuant to notice, at 2 p.m. in room SD-215, Dirksen Senate Office Building, Hon. Malcolm Wallop (chairman of the Subcommittee on Energy and Agricultural Taxation) presiding.

Present: Senators Wallop (presiding), Grassley, Dole, Symms, and Baucus.

Senator WALLOP. Good afternoon. The purpose of our hearing this afternoon is to hear from the administration and other interested witnesses on the possible tax consequences of participation in the recently announced payment-in-kind program, what is known as PIK.

[The committee press release, the description of PIK by the Joint Committee on Taxation and the text of S. 446, S. 495, and S. 527 follow:]

[Press release No. 83-113, February 18, 1983]

FINANCE SUBCOMMITTEES ON ENERGY AND AGRICULTURAL TAXATION AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE SET HEARING ON PAYMENT-IN-KIND TAX LEGISLATION

Senator Malcolm Wallop, Chairman of the Subcommittee on Energy and Agricultural Taxation of the Committee on Finance and Senator Charles E. Grassley, Chairman of the Finance Subcommittee on Oversight of the Internal Revenue Service, announced today that the two Subcommittees will hold a hearing on Monday, February 28, 1983, on legislation to clarify the tax treatment of crop payments under the Agriculture Department's Payment-In-Kind (PIK) program.

The hearing will begin at 2:00 p.m. in Room SD-215 of the Dirksen Senate Office Building.

In announcing the hearing, Senator Wallop said, "If the PIK program is to have a chance, several important tax issues must be resolved before March 11 of this year, the last day farmers can sign up to participate in the program."

Senator Wallop said that the existence of several tax problems was a serious impediment to participation in the PIK program for many farmers, but he added that the tax problems were far from insurmountable, if Congress can simply take time to focus on them.

Senator Grassley said he expects "that the Administration and the Congress will cooperate to the fullest extent to see that farmers are not adversely affected by following federal agriculture policy."

The specific proposals that will be considered include S. 446, introduced by Senators Jepsen, Grassley, and Dole, and S. 527, introduced by Senators Grassley and Wallop. These bills are intended to treat a farmer's receipt of a PIK payment, for Federal estate and income tax purposes, as if the PIK crop had been actually grown by the recipient.

DESCRIPTION OF
TAX MATTERS RAISED BY THE
PAYMENT-IN-KIND (PIK) PROGRAM
INCLUDING A DESCRIPTION OF
S. 446, S. 495, AND S. 527

Scheduled for A Hearing
on February 28, 1983
Before the
Subcommittee on Energy and Agriculture Taxation
and the
Subcommittee on Oversight
of the Internal Revenue Service
of the
Committee on Finance

Prepared by the Staff
of the
Joint Committee on Taxation

February 25, 1983
JCX-5-83

INTRODUCTION

The Subcommittee on Energy and Agricultural Taxation and the Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance has scheduled a hearing, to be held on February 28, 1983, on the tax matters raised by the agricultural commodities payment-in-kind (PIK) program. The hearing will consider specifically S. 446, introduced by Senators Jepsen, Dole, Grassley, Wallop, Durenberger, and Pryor, S. 495, introduced by Senator Baucus, and S. 527, introduced by Senators Grassley, Wallop, Bentsen, Boren, Symms, Roth, and Danforth.

The first part of this document is a summary of S. 446, S. 495, and S. 527 and other tax matters raised by the PIK program. The second part is a description of the PIK program. The third part is a description of present law relating to the tax matters raised by the PIK program. The fourth part is a description of the tax issues raised by the PIK program. The fifth part is a description of S. 446, S. 495, and S. 527, including revenue effects. The sixth part provides a description of prior Congressional action on the tax treatment of the PIK program.

I. SUMMARY

The Administration (Department of Agriculture) has adopted a payment-in-kind (PIK) program under which farmers are paid with commodities for diverting all or certain portions of their farmland from production.

S. 446 would permit farmers to defer the recognition of income from commodities, actually or constructively, received under the PIK program until the commodities are sold. The bill would treat commodities received under the PIK program as grown on the real property withdrawn from production under the program for purposes of determining whether the real property is used in an active farming (i.e., qualified) use as required by the estate tax current use valuation provision.

S. 495 would permit farmers to elect to defer recognition of income from commodities, actually or constructively, received under the PIK program until the commodities are sold. The bill would treat property withdrawn from production in exchange for a fixed payment under any Federal farmland removal program as used in an active farming (i.e., qualified) use for purposes of the estate tax current use valuation provision. Additionally, withdrawal of real property from production under the PIK program would not be construed to prevent satisfaction of the current use valuation material participation requirements.

S. 527 would permit farmers to defer the recognition of income from commodities, actually or constructively, received under the PIK program until the commodities are sold. The taxpayer would be treated as the producer of the commodity for all purposes of the Code and the Social Security Act.

The bill would treat real property removed from production under the PIK program as used in an active farming (i.e., qualified) use for purposes of the estate tax current use valuation provision. A maximum of three years of PIK participation could be considered as use in a qualified use.

The bill would also treat real property otherwise used in an active trade or business which is withdrawn from production under the PIK program as used in such a trade or business for purposes of the estate tax installment payment provision.

II. DESCRIPTION OF THE PAYMENT-IN-KIND ("PIK") PROGRAM

Overview

The Department of Agriculture's payment-in-kind ("PIK") program is a program for diverting from production land which otherwise would be used to produce crops of wheat, corn, sorghum, rice, and upland cotton. Under the program, producers will be provided a quantity of a commodity as compensation for diverting acreage normally planted in that commodity. As presently announced, the PIK program applies only for the 1983 acreage reduction program.

The PIK program is in addition to the previously established acreage reduction and price support programs available to farmers. The previous programs provide for cash, rather than in-kind, payments. Farmers must be participants in these cash payment programs as a condition of eligibility for the PIK program.

PIK Program

General rules.--Under the PIK program, farm producers generally may elect to divert from 10 to 30 percent of their crop acreage base[1] from active crop production in exchange for a payment-in-kind equal to an established quantity of the commodity normally grown on the property. The established percentage is the farm's program yield[2] times 95 percent for wheat and 80 percent for corn, grain, sorghum, upland cotton, and rice multiplied by the PIK acreage.

In lieu of the guaranteed 10 to 30 percent PIK diversion election, farmers may elect to divert the whole crop acreage base (other than property in the cash diversion program) for the farm on a bid basis. If a whole crop bid is made, the farmer offers to reduce his or her planted acreage of the crop to zero. As part of his or her bid, the farmer specifies the percent of the farm's program yield that he or she will accept as compensation. The lowest bids will be accepted first. If the whole base bid is accepted, the bid compensation rate applies to the entire PIK acreage. If the

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[1] The term crop acreage base means the acreage devoted to production of the crop involved during a base period. The crop base is presently established under the Omnibus Reconciliation Act of 1982.

[2] The term farm program yield means the yield of the crop covered by a PIK contract on the farm property during an established historical reference period.

whole base bid is not accepted, the farmer is still entitled to PIK diversion of 10 to 30 percent of his or her crop acreage base at the established compensation rate for the crop involved.

Whether whole base PIK bids will be accepted depends on the amount of property for which PIK elections are made in the county where the property is located. The total acreage withdrawn from production of a crop under all Federal government land diversion programs cannot exceed 50 percent of the total acreage base for the crop in any county. All 10 to 30 percent elections will be accepted before any whole base bids are accepted.

If a farmer has a crop base in more than one crop included in the PIK program, he or she may elect to utilize the program for any combination or all of the crops. The total crop base diverted cannot, however, exceed the total acreage comprising the farm.

Property withdrawn from crop production under the PIK program must be devoted to conservation uses. Generally, this will result in the property being planted with a cover crop to prevent erosion and otherwise being permitted to lie fallow. The PIK acreage may be grazed other than during the six principal growing months of the PIK crop. Harvesting of any crop from land diverted under the PIK program generally will be prohibited.

Applications for both the guaranteed percentage PIK program and the whole base bid program must be submitted by March 11, 1983. All 1983 contracts must be signed by March 17, 1983. Whole base bids will be accepted or rejected at public county meetings on March 18, 1983. Executed PIK contracts are transferable by the farmer under certain circumstances; however, failure to comply with the contract terms can result in forfeiture of payments and, in certain cases, in liquidated damages.

Payment procedures.--Participating farmers will be eligible for payment-in-kind on a date established for their locality. The payment dates range from June 1 for wheat in certain Southern areas to November 1 for corn in certain Northern States. The payment availability dates reflect the usual harvest dates of PIK crops in different regions. Farmers may receive payment on the established availability date, or they may elect to defer receipt of the payment for any period of time up to 5 months thereafter. The Federal Government bears all risk of loss and storage costs until payment is received by the farmer.

The PIK commodities will be paid from surplus commodities held by the Federal Government. The Federal Government acquires these commodities through loan

cancellations in the crop loan and price support programs administered by the Commodity Credit Corporation ("CCC")[3] and the Farmer-owned Reserve ("FOR").[4] The CCC and FOR programs are similar, except CCC loans are normally made for a 9-month period while FOR stocks generally are held off the market for 3 years. In the case of payment from farm-stored FOR stocks, farmers will be paid an additional 7 months of storage costs beyond the normal 5 months allowed under the PIK program.

The method of payment under the PIK program will vary, depending on whether the farmer has outstanding loans with the CCC or has grain in the FOR. If the farmer has no commodities pledged under these programs, he or she will receive payment from government stocks of the commodity involved. If the farmer has commodities pledged under either of the programs, the payment will take the form of a 3-step transaction. First, the farmer will repay an amount of his outstanding loans equal to the PIK payment[5]. At that time, a pro rata portion of the loan security will be released. Second, the Government will repurchase the released commodities for an amount equal to the amount of the repaid loan (plus any accrued interest and storage charges paid by the farmer on repayment of the loan). Finally, the Government will return the commodities to the farmer as a payment-in-kind under the PIK contract.

Special procedures for upland cotton and rice.--PIK payments of upland cotton and rice generally will be made by the Government to a farmer's cooperative. If an upland cotton or rice producer markets his or her crop through a

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[3] The CCC is a Federally-owned corporation which administers the farm price support program through grants of loans on crops eligible for support. The CCC establishes an annual loan rate per unit for each crop eligible for government price supports. CCC then makes nonrecourse loans to farmers for their crops based upon this rate. If the market price for the crop rises above the loan rate, the farmer can redeem the crop, sell it, and retain any excess proceeds over the loan rate. If the market price does not rise above the loan rate before the loan's due date, the farmer can forfeit the crop to the Government in full satisfaction of the loan.

[4] A portion of the commodities will be acquired through transactions, the substance of which is loan cancellation, with farmers who have such loans outstanding immediately before they receive payments of commodities under the PIK program.

[5] Except in the case of upland cotton, the farmer can choose which loans to repay. Cotton loans must be repaid in the order in which the crops under loan were produced.

cooperative, the cooperative will receive the payment otherwise due the farmer under the PIK contract. Other farmers may elect to have cooperatives receive payments otherwise due them provided the farmers have no outstanding CCC loans themselves. The payment procedures for cooperatives will be the same as for individual farmers dealing directly with the Government. PIK payments to cooperatives will be held in pools separate from other crops held by the cooperatives.

Cash Payment Acreage Reduction Program

As stated in the Overview, farmers must participate in the cash payment acreage reduction program as a prerequisite of eligibility for the PIK program. This cash diversion program consists of two facets. First, the farmer must divert from production an established percentage of his or her acreage base in exchange for diversion payments.[6] This required percentage varies with the crop--wheat, feed grains, corn, rice, and upland cotton. The payment is a statutorily prescribed amount per crop unit times the farm program payment yield for each acre diverted.

Second, the farmer must divert from production an additional percentage of his or her otherwise planted crop acreage for no pay. As with the so-called paid diversion, this no pay percentage varies with the crop involved (e.g., 12-1/2 percent for corn at the present time). These two diversion requirements generally result in approximately 20 percent of the farmer's crop acreage base being withdrawn from production in addition to any land so withdrawn under the PIK program. As with acreage in the PIK program, property withdrawn under the cash payment program must be devoted to conservation use.

Participation in the cash payment program also entitles the farmer to deficiency (price-support) payments with respect to crops actually produced. The deficiency payments are equal to the excess of an established "target" price over the greater of the year's CCC loan value for the crop or the crop's national average market price.

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[6] The Omnibus Reconciliation Act of 1982 authorized advance payment of prescribed percentages of payments for 1982 and 1983 crops (normally made in 1983 and 1984) during 1982. Additional advance payments of 1983 crops (normally made in 1984) are permitted in 1983. Advance payments are made at the option of the farmer.

III. PRESENT LAW

A. Income Tax Treatment of Farmers

1. Timing of Income

Generally, taxpayers engaged in farming may determine their income for Federal income tax purposes under either the cash or accrual method of accounting. However, corporations (other than certain "family owned" corporations, subchapter S corporations and certain corporations with annual gross receipts of less than $1 million) and certain partnerships must use the accrual method of accounting for farm operations (Code sec. 447).

Under the cash method of accounting, income is recognized for the year in which it is actually or constructively received. Income is constructively received by a taxpayer when it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time (Treas. Reg. sec. 1.451-2(a)). A taxpayer who uses the cash method of accounting must recognize income when he is entitled to receive commodities under a payment-in-kind program.

Under the accrual method of accounting, income is generally recognized when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy, regardless of when received (Treas. Reg. sec. 1.451). A taxpayer who uses the accrual method of accounting must recognize income when he has the right to receive commodities under a payment-in-kind program, regardless of the time of actual receipt.

Thus, under both the cash and accrual methods of accounting, the taxpayer will recognize income when the commodities are made available to the farmer. In addition, under both methods, when property rather than cash is received, the amount to be included in income is the fair market value of the property on the date the taxpayer recognizes the income.

A taxpayer may elect to consider amounts received as loans from the CCC as income in the year in which received (Code sec. 77). If the election is made and the commodity securing such loan is later forfeited, no income would be recognized at the time of such forfeiture. If the election is made and the commodity securing the loan is later sold, the taxpayer's basis in the commodity is an amount equal to the income previously recognized in the year the loan

proceeds were received.

Generally, a taxpayer may elect to defer the income from the discharge of indebtedness on qualified business indebtedness. The deferral of the income is achieved by excluding the income from discharge of indebtedness (Code sec. 108) but with a corresponding reduction in the basis of certain assets (Code sec. 1017).

A farmer, who has commodities pledged for outstanding loans under the CCC or FOR programs, generally will receive his or her pledged commodity as a payment-in-kind under the PIK contract with a corresponding reduction in the amount of the CCC or FOR loan. However, as indicated in the discussion of the PIK program, this result will be achieved through a three-step process under which the loans are first repaid, followed by a purchase by the Federal Government of the commodity, and then a payment-in-kind of that commodity. It is unclear, under present law, whether such series of transactions will be treated as discharge of indebtedness or will follow the form of the transaction and be treated as a repayment of the loan by the farmer, a sale of the commodity to the CCC, and a return of the commodity to the farmer as a payment-in-kind.

2. Time for Payment of Tax

In general, a taxpayer is required to pay the tax shown on a tax return on the due date for filing the return (determined without regard to any extensions of time for filing the return). Corporations generally must pay at least 90 percent, and individuals 80 percent, of their current year's tax liability in quarterly estimated tax payments during the taxable year.

However, an individual whose estimated gross income from farming for the taxable year is at least two-thirds of his or her total estimated gross income from all sources for the taxable year (or whose gross income from farming shown on the preceding year's tax return is at least two-thirds of total gross income from all sources) must pay the estimated tax for a taxable year in full on or before January 15 of the succeeding taxable year.

Additionally, the requirement to make payments of estimated tax would be considered met if, on or before March 1, the taxpayer files a return for the taxable year for which estimated tax payments are required and pays in full the amount of tax due (Code secs. 6015(g), 6073(b), and 6153(b)). Corresponding payment dates would apply to taxable years beginning on a date other than January 1st. However, the addition to the tax with respect to underpayment of estimated taxes will not be imposed if the estimated tax payments are at least 66-2/3 percent of the tax liability for the year

(Code sec. 6654(d)).

3. Method of Accounting for Corporations Engaged in Farming

Generally, taxpayers engaged in farming may determine their incomes for Federal income tax purposes under either the cash or accrual method of accounting. However, corporations (other than certain "family owned" corporations, subchapter S corporations, and certain corporations with annual gross receipts of less than $1 million) and certain partnerships that are engaged in the trade or business of farming are required to be on the accrual method (Code sec. 447).

4. Soil and Water Conservation Expenditures

Under present law, a taxpayer engaged in the business of farming may expense amounts which are paid or incurred during the taxable year for the purpose of soil or water conservation in respect of land used for farming, or for the prevention of erosion of land used for farming, but not in excess of 25 percent of the gross income derived from farming during the taxable year (Code sec. 175). Any amount not deductible in any taxable year because of the 25 percent of gross income limitation may be deducted in succeeding taxable years in the order of time so long as any taxable year's deductions under this provision do not exceed 25 percent of gross income from farming for that taxable year.

The term "land used in farming" means land used (before or simultaneously with the expenditures described above) by the taxpayer or his or her tenant for the production of crops, foods, or other agriculture products or for the sustenance of livestock.

Under present law, if a taxpayer disposes of farm land which he or she has held for fewer than 10 years, a certain proportion of the gain realized on the disposition is treated as ordinary income (Code sec. 1252). That proportion is the lower of a percentage of the aggregate deductions allowed under sections 175 and 182 for expenditures made with respect to the farm land after 1969, or the excess of the amount realized (or the fair market value) over the adjusted basis of such land. For this purpose, the term "farm land" is land with respect to which deductions have been allowed under sections 175 or 182.

5. Expenditures by Farmers for Fertilizer, etc.

Under present law, a taxpayer engaged in the business of farming may elect to expense amounts that otherwise must be capitalized which are paid or incurred

during the taxable year for materials to enrich, neutralize, or condition land used in farming, or for the application of such materials to the land (Code sec. 180). For this purpose, land is used in farming if it is used, either before or simultaneously with the expenditures described above, by the taxpayer or his or her tenant for the production crops, fruits, or other agricultural products, or for the sustenance of livestock.

6. Expenditures by Farmers for Clearing Land

Under present law, a taxpayer engaged in the business of farming may elect to treat expenditures paid or incurred in a taxable year to clear land for the purpose of making such land suitable for use in farming as a currently deductible expense (Code sec. 182). However, this deduction for any taxable year may not exceed the lesser of $5,000 or 25 percent of the taxable income derived from farming during the taxable year (as defined). Such expenditures are subject to recapture under section 1252 (see item 4, above).

7. Activities Not Engaged in for Profit

Under present law, if an individual or a Subchapter S corporation engages in an activity not for profit, no deduction (other than itemized deductions) attributable to such activity is allowable in excess of the income from that activity (Code sec. 183).

8. Gain from Disposition of Property Used in Farming or Farm Losses Offsetting Farm Income

Under section 1251, any person carrying on a trade or business of farming, other than any person utilizing the accrual method of accounting, is required to maintain an excess deductions account (EDA). Prior to taxable years beginning after December 31, 1975, any person having a farm net loss (the excess of farm deductions over gross income derived from farming), was obligated to add such amount to his EDA.

If, at the end of any taxable year, the EDA has a positive balance, then the amount of the EDA is reduced (1) for any farm net income (the excess of farming gross income over farm deductions for that taxable year), (2) for any amounts with respect to deductions which do not result in a tax deduction for the taxpayer, and (3) the amount realized from the sale, exchange, or involuntary conversion of farm recapture property. Farm recapture property includes depreciable personal property held for more than one year, certain cattle or horses, land held for more than one year, and unharvested crops growing on land which has been held for more than one year.

9. Qualification of Corporations for Subchapter S Status

Under present law, certain closely held corporations (commonly called "subchapter S corporations") can elect to have their income taxed to the shareholders and not the corporation, regardless of whether or not it is actually distributed during the year (Code sec. 1371-9).

One requirement for electing subchapter S status for corporations which had accumulated earnings and profits while it was not a subchapter S corporation is that during the last three taxable years prior to the election no more than 25 percent of the gross receipts of the electing corporation be passive investment income. Passive investment income is defined to include gross receipts received from rents.

10. Self-employment Income

A self-employment tax is imposed on net earnings from self-employment as defined by section 1402. Net earnings from self-employment means gross income derived by an individual from any trade or business, less allowable deductions attributable to such trade or business. Rentals from real estate including rentals paid in crop shares are excluded in determining net earnings from self-employment, unless such rentals are received in the course of a trade or business as a real estate dealer. However, this exemption does not apply to any income derived by a landlord if (1) the income is derived under an arrangement entered into between the landlord and another individual which provides for the landlord's material participation in the production or management of the production of the agricultural or horticultural commodities to be produced on the land by the individual, and (2) there is material participation by the landlord with respect to any such commodity. Thus, income which is received by a farmer who materially participates in the production of the income is treated as self-employment income.

11. Limitation on Deduction of Investment Interest

In general, all interest paid or accrued during the taxable year on indebtedness is allowable as a deduction. However, if a taxpayer other than a corporation pays or accrues an amount of investment interest, then the otherwise allowable deduction with respect to that interest cannot exceed $10,000 ($5,000 in the case of a separate return by married individual), plus net investment income.

Investment interest is interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. Net investment income means

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gross income from interest, dividends, rents, and royalties, and certain other income from passive sources, to the extent it exceeds investment expense. Investment expense means certain expenses deductible under various provisions of the Internal Revenue Code attributable to investment items.

12. Imposition of Tax on Unrelated Business Income of Charitable, etc. Organizations

A tax is imposed for each taxable year on the unrelated business taxable income of certain exempt organizations. The term "unrelated business taxable income" means the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less deductions allowed which are directly connected with the carrying on of such trade or business. In general, however, all rents from real property are excluded from the computation of unrelated business taxable income.

13. Imposition of Personal Holding Company Tax

An additional tax is imposed on the undistributed personal holding company income of every personal holding company. This tax is equal to 50 percent of the undistributed personal holding company income.

In general, a personal holding company is any corporation, other than certain specified types of corporations, at least 60 percent of the adjusted ordinary income of which is personal holding company income. In addition, more than 50 percent in value of the outstanding stock of a personal holding company must be owned, directly or indirectly, by 5 or fewer individuals during the last half of the taxable year. The term "personal holding company income" includes adjusted income from certain rents and royalties.

B. Tax Treatment of Cooperatives

A cooperative is an organization, usually operating in corporate form, which is established and operated for the mutual benefit of its members and patrons by selling goods to them or purchasing products from them and returning to them any income in excess of costs. Unlike other corporations, a cooperative is allowed a deduction from its taxable income to the extent patronage source income is distributed to its members or patrons as a patronage dividend or in redemption of a non-qualified written notice of allocation. Additionally, a cooperative may exclude income attributable to qualified per-unit retain allocations and redemptions of nonqualified per-unit retain certificates. Patronage

dividends (whether paid in cash, in qualified written notices of allocation, or in redemption of nonqualified written notices of allocation) are includible in the income of a member or patron when paid or allocated. In general, an amount is a patronage dividend if it is payable out of patronage source income to all patrons of the cooperative equally on the basis of business done with or for patrons.[7] A per-unit retain allocation is, in general, an amount retained by the cooperative with respect to goods marketed by the cooperative for the patron.

Patronage source income is income directly related to business done with or for patrons. Thus, for example, investment income and income derived from the sale or exchange of capital assets is nonpatronage source income. A patron is any person doing business with the cooperative on a mutual basis.

Exempt farmers' cooperatives are allowed more beneficial tax treatment than nonexempt cooperatives in two respects. First, they are allowed a deduction for dividends paid from nonpatronage source income (including income from business done with or for the United States) to their patrons (not including the United States or its agencies). Second, they are allowed a deduction for amounts paid as dividends on their capital stock during the taxable year as long as the dividends do not exceed the greater of 8 percent or the legal rate of interest in the State of incorporation.

A nonexempt cooperative is any cooperative other than an exempt farmers' cooperative. Nonexempt cooperatives cannot deduct dividends of nonpatronage source income, but they are not limited in the sources or amounts of their nonpatronage source income.

C. Estate Tax Treatment of Farmers

1. Current Use Valuation of Certain Farm Real Property

Qualification of Decedent's Estate

For estate tax purposes, real property ordinarily must be included in a decedent's gross estate at its fair market value based upon its highest and best use. If certain

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[7] A patronage dividend must be payable (1) on the basis of the quantity or value of business done with or for the patron, (2) under an obligation to pay such amount which obligation existed when the cooperative received the amount, and (3) with reference to the net earnings of the cooperative from business done with or for its patrons.

requirements are met, however, real property used in family farm operations and other closely held businesses may be included in a decedent's estate at its current use value, rather than its full fair market value. The maximum reduction in value permitted under the current use valuation provision is $750,000 per estate (Code sec. 2032A).

One of the requirements for specially valuing property is that minimum percentages of the decedent's estate must consist of real property which, among other attributes, has been used in a "qualified use" during certain specified periods. First, at least 50 percent of the adjusted value[8] of the decedent's estate must consist of the adjusted value of real and personal property used in a qualified use on the date of the decedent's death. Second, at least 25 percent of the adjusted value of the decedent's estate must consist of real property used in a qualified use. Third, all real property to be specially valued must have been used in a qualified use both on the date of the decedent's death and for periods aggregating at least 5 years of the 8-year period ending on the date of death.

Another requirement is that the decedent or a member of his or her family must materially participate in the farming operation in which the real property to be specially valued is used. Material participation must occur during periods aggregating at least 5 years of the 8-year period ending on the date of the decedent's death. A special rule for individuals who are retired or disabled on the date of their deaths permits the material participation requirement to be satisfied by disregarding periods after the individuals began receiving social security benefits or became disabled, if the retirement or disability was continuous until the date of death.

Recapture of Tax Savings in Certain Circumstances

If, within 10 years[9] after the death of the decedent (and before the death of the heir receiving the property), specially valued property is disposed of to nonfamily members or ceases to be used for the farming or other closely held business purpose based upon which it was valued in the decedent's estate (i.e., its "qualified use"), all or a

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[8] The adjusted value of a decedent's estate is equal to the gross value of the estate minus indebtedness payment of which is secured by property in the estate. Similarly, the adjusted value of an asset is equal to the gross value of the asset minus indebtedness payment of which is secured by the asset.

[9] The recapture period is 15 years in the case of estates of decedents who died before 1982.

portion of the Federal estate tax benefits obtained by virtue of the reduced valuation are recaptured by means of a special "additional estate tax" or "recapture tax." During the recapture period, the qualified use requirement must be satisfied at all times.[10]

The recapture tax is imposed on the qualified heir rather than the decedent's estate. However, the tax liability is measured by reference to the estate tax saved by the decedent's estate. In the case of a partial cessation of qualified use, the recapture tax is prorated based upon the percentage of the specially valued property that is no longer used in the qualified use.

Material participation in the farm operation is also required during the recapture period. Except in the case of "eligible qualified heirs,"[11] the heir receiving the property or a member of the heir's family must materially participate in the farm operation for periods aggregating at least 5 years of every 8-year period ending after the date of the decedent's death and before expiration of the recapture period. Failure to satisfy the material participation requirement during the recapture period is deemed to be a cessation of qualified use.

Definition of Qualified Use

The term qualified use has the same meaning under both the pre-death requirement and the recapture period requirement. In general, a qualified use is a use in farming or in another closely held business. The business in which specially valued real property is used must be an active operation, as opposed to a passive investment activity. In the case of farms, the activity requirement is normally satisfied by the production of crops or raising of animals for profit.[12]

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[10] A special rule disregards a period beginning on the decedent's date of death and ending not more than 2 years later; however, the recapture period is extended by a period equal to any part of this 2-year period when the qualified use requirement is not satisfied.

[11] An eligible qualified heir can satisfy the material participation requirement through "active management," a lesser standard of personal involvement than material participation. Eligible qualified heirs include surviving spouses, minors, full-time students, and disabled individuals.

[12] A so-called "hobby farm" which is an activity not engaged

(Footnote continued)

Additionally, the decedent or a family member (during pre-death periods) and each qualified heir owning a present interest in the property (during the recapture period) must own an equity interest (i.e., be at risk) in the business operation. The element of risk must be as to both price and production. Thus, for example, the qualified use requirement is not satisfied during any periods when the party who is to satisfy the qualified use requirement withdraws the property from productive use[13] or leases the property pursuant to a net cash or other fixed return lease.

Because real property is withdrawn from crop production under the payment-in-kind ("PIK") program in exchange for a fixed payment, such real property may not be considered to be used in a qualified use.

Definition of Material Participation

Material participation means personal involvement in an active farming operation to a material degree. The determination of whether this requirement is satisfied is factual and is based on factors such as participation in making business decisions, inspection of crops, and other farm activities in which the participant engages.

Material participation for purposes of the current use valuation provision is defined by reference to the meaning of the same term as used in the social security tax provisions. Therefore, the participant's activity must be sufficient to convert his or her income from "passive rentals" to "earned income" for purposes of the self-employment income (SECA) tax. As earned income, the farm income is subject to the SECA tax. In addition, for certain persons under age 70, social security benefits may in some cases be reduced if this income exceeds prescribed amounts.

It is unclear under present law whether management of land withdrawn from production under the PIK program is used in a farming operation involving sufficient personal involvement to constitute material participation.

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12 (continued)
in for profit under section 183 does not satisfy the qualified use requirement (Treas. Reg. sec. 20.2032A-3(b)(1)).

13 Property permitted to lie fallow during nonproducing seasons or as part of a regular crop rotation program is treated as satisfying the requirement during these temporary periods.

2. Installment Payment of Estate Tax

Overview

In general, estate tax must be paid within 9 months after a decedent's death. However, if at least 35 percent of the value of the decedent's adjusted gross estate is comprised of the value of an interest in the closely held business and if certain other requirements are satisfied, payment of estate tax attributable to the interest in the closely held business may be extended and paid in installments during up to 14 years (interest for 4 years followed by from 2 to 10 annual payments of principal and interest). The determination of whether the decedent owns an interest in a closely held business is made as of the decedent's date of death (Code sec. 6166).

A special 4-percent interest rate is provided for estate tax attributable to the first $1 million in value of the closely held business interest (Code sec. 6601(j)). Tax in excess of this amount ($345,000 of tax less the amount of decedent's unified credit) accrues interest at the regular rate charged on deficiencies (Code sec. 6601(a)). The regular deficiency rate currently is 16 percent.

Under present law, proprietorships owned by the decedent may qualify as an interest in a closely held business. In addition, an interest in a closely held business may include interests in partnerships and corporations if certain "percentage tests" or "numerical tests" are satisfied.

Definition of trade or business

Only interests in active trades or businesses, as contrasted to passive investment assets, are eligible for the intallment payment provision. The determination of whether an interest in an active trade or business is present is factual and must be made on a case-by-case basis.

In Revenue Ruling 75-366, 1975-2 C.B. 472, the decedent leased real property to a tenant on a crop share basis. In addition to sharing in the farm expenses and production, the decedent actively participated in important management decisions. The Internal Revenue Service ruled that the decedent was in the business of farming under these facts stating:

> An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant, and if he receives a rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise which is like a manufacturing enterprise as distinguished from management of

investment assets.

In the present case, the decedent had participated in the management of the farming operations and his income was based upon the farm production rather than on a fixed rental.

Accordingly, the farm real estate included in the decedent's estate qualifies...as an interest in a closely held business. (Id.)

IV. Issues Presented by the PIK Program

A. Income Tax Treatment of Farmers--Timing of Income

The first issue raised by the PIK program is whether a farmer should recognize income from participation in the PIK program at the time he or she is entitled to receive the commodity, at the time he or she actually receives the commodity, or at the time he or she disposes of the commodity.

B. Income Tax Treatment of Farmers--Miscellaneous Issues

The second issue is whether income derived from the sale or other disposition of PIK commodites should be treated as gross income from farming and whether land diverted from production under the PIK program should be treated as land used in the trade or business of farming under a number of provisions of the Code. These provisions include, but are not limited to:

(1) payments of estimated tax;

(2) method of accounting by corporations engaged in farming;

(3) expensing of certain soil and water conservation expenditures;

(4) expensing of certain expenditures by farmers for fertilizer;

(5) expensing of certain expenditures by farmers for clearing land;

(6) deductibility of expenses attributable to activities not engaged in for profit;

(7) gain from disposition of property used in

farming or farm losses offsetting farm income;

(8) qualification of corporations for subchapter S status;

(9) application of self-employment tax;

(10) limitation on deduction of investment interest;

(11) tax on unrelated business income of charitable, etc., organizations; and

(12) tax on personal holding companies.

C. Income Tax Treatment of Farmers--Treatment of Cooperatives

The third issue is whether the income derived from the sale or the disposition of PIK commodities received by a producer and marketed through a cooperative, or received directly by a cooperative on behalf of the producer, should be treated as patronage source income.

D. Estate Tax Treatment of Farmers

The fourth issue is whether the requirement that all specially valued real property be put to productive use in an active business operation in which the decedent or a member of his or her family (during pre-death periods) or the qualified heir (during the recapture period) is at risk should be modified to permit property that is withdrawn from production in exchange for a fixed payment-in-kind by the Federal Government to qualify for current use valuation.

The fifth issue is wnether the current use valuation material participation requirement should be modified to provide that material participation is present with respect to farm real property that is withdrawn from production in exchange for a fixed payment-in-kind by the Federal Government.

The sixth issue is whether land diverted from production under a fixed payment-in-kind program should qualify for installment payment of estate tax.

V. DESCRIPTION OF THE BILLS

A. Description of S. 446

1. Income Tax Treatment of Farmers--Timing of Income

S. 446 would provide that a taxpayer who receives any commodity under a certified payment-in-kind program would not recognize income by reason of the right to receipt of such commodity until the commodity is sold or exchanged. Thus, both accrual and cash basis taxpayers could defer the recognition of income, that would otherwise be recognized under current law in the year the taxpayer has a right to receive the commodities until the year the commodities are sold or exchanged.

For purposes of determining the amount of gain from a sale or exchange of the commodities, the taxpayer would be treated as having zero basis in the commodity. Such gain would be treated as ordinary income.[14]

These provisions would apply to taxable years beginning after December 31, 1982.

2. Estate Tax Treatment of Farmers--Current Use Valuation

S. 446 would provide that commodities received under a certified payment-in-kind (PIK) program are treated as produced by the recipient on the real property withdrawn from production under the PIK program. Therefore, under the current use valuation provision, the real property would be treated as used in an active farming (i.e., qualified) use during periods when it was withdrawn from production under the PIK program for the following purposes:

(1) Determining whether real property was used in a qualified use for periods aggregating at least 5 years of the 8-year period ending on the decedent's date of death;

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[14] This bill does not address the proper treatment of income derived from the sale or other disposition of commodities received under a payment-in-kind program (or the treatment of land diverted from production under such a program) for other purposes of the Code. Also, this bill does not address the proper treatment of cooperatives (both exempt and non-exempt) marketing PIK commodities received, by or on behalf, of a farmer participant.

(2) Determining whether the real property was used in a qualified use on the decedent's date of death; and

(3) Determining whether the real property was used in a qualified use during the post-death recapture period.[15]

This provision would apply to estates of individuals dying after December 31, 1976.

B. Description of S. 495

1. Income Tax Treatment of Farmers--Timing of Income

S. 495[16] would provide an election for a taxpayer who would otherwise be required to recognize income under present law on receipt of any agricultural commodity under a Federal farmland removal program to treat the commodity as if it were produced by the taxpayer. If the taxpayer elects this treatment, both accrual basis and cash basis taxpayers would recognize income when the commodity is sold. For purposes of determining the amount of gain on the disposition of the commodity, the taxpayer's basis in the commodity would be zero.

This bill would also provide an election for a taxpayer who would otherwise be required to recognize income by reason of the cancellation of a qualified support loan. The taxpayer could elect to recognize income in the year the commodity which secures the loan is disposed of (or consumed). The amount to be included in income in a year would bear the same ratio to total income from the cancellation of the loan as the amount of the commodity sold in such year bears to the total amount of the commodity which secured the loan.

These elections could be made separately with respect to each receipt of a commodity and each loan cancelled.[17]

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[15] This bill does not address qualification of PIK real property for the estate tax installment payment provision.

[16] S. 495 is substantially similar to H.R. 1296 introduced in the House of Representatives by Congressman Harkin and others on February 7, 1983.

[17] S. 495 does not address the proper treatment of income derived from the sale or other disposition of commodities received under a certified payment-in-kind program (or the treatment of land diverted from production under such a program) for other purposes of the Code. Also, this bill does not address the proper treatment of cooperatives (both exempt and non-exempt) marketing PIK commodities received, by or on behalf, of a farmer participant.

These provisions would apply to taxable years ending after December 31, 1982.

1. Estate Tax Treatment of Farmers--Current Use Valuation

S. 495 would provide that, for purposes of the current use valuation provision, real property withdrawn from production under any Federal farmland removal program in exchange for any fixed payment from the Federal Government would be treated as used in an active farming (i.e., qualified) use during periods when it was withdrawn from production under the Federal program for the following purposes:

(1) Determining whether real property was used in a qualified used for periods aggregating at least 5 years of the 8-year period ending on the decedent's date of death;

(2) Determining whether the real property was used in a qualified use on the decedent's date of death; and

(3) Determining whether the real property was used in a qualified use during the post-death recapture period.

S. 495 would also provide that removal of real property from production under any Federal farmland removal program would not be construed to prevent satisfaction of the material participation requirements of the current use valuation provision.

These provisions of the bill would apply to estates of individuals dying after December 31, 1982.

C. Description of S. 527

1. Income Tax Treatment of Farmers--Timing of Income

S. 527 would provide that a taxpayer who receives, or is entitled to receive, any commodity under a payment-in-kind program would not be required to recognize income by reason of such receipt or entitlement until the commodity is sold or exchanged. Thus, both accrual and cash basis taxpayers would defer the recognition of income, that would otherwise be recognized under current law in the year the commodities, are entitled to be received, until the year the commodities are sold or exchanged.

For purposes of determining the gain or loss from the

sale or other disposition of the commodity, the basis of the commodity would be zero. The commodity would be treated as produced by the taxpayer for purposes of determining the character of the gain (ordinary income or capital gain) from the sale of the commodity or, if the commodity is used by the farmer (e.g., as feed), from the sale of the property (e.g., livestock) the basis of which includes the basis of the commodity.

As discussed in Part II (Description of the Pament-in-kind (PIK) Program), the payment-in-kind of a commodity where there are outstanding CCC (or FOR) loans may involve a 3-step process: the repayment by the taxpayer of a loan from the CCC, the purchase by the CCC of the commodity securing the loan, followed by the receipt (or entitlement to receipt) of the commodity by the taxpayer as a payment-in-kind. In any such case, the taxpayer who receives the commodity, as payment-in-kind in the third step of this 3-step process, would be entitled to the same tax treatment on such receipt as a taxpayer who receives a payment-in-kind where a CCC loan is not involved.

If, with respect to the CCC loan, the taxpayer had made an election under section 77 to recognize income in the year the loan proceeds were received, the repayment of the loan and the purchase by the CCC of the commodity (the first and second steps of the 3-step process) would be treated as a transaction closing the sale of the commodity. The taxpayer would not recognize income, as under present law, at the time of such closing because the taxpayer would have already recognized income when the loan proceeds were received.

In the case of a taxpayer who had not made such an election under section 77, the repayment of the CCC loan and the purchase by the CCC of the commodity securing the loan (the first and second steps of the 3-step process) would be treated as a sale of the commodity by the taxpayer. The taxpayer would recognize income, as under present law, at the time of such sale.

As part of the payment-in-kind program, the taxpayer may receive reimbursement for storage costs. The bill would provide that a cash basis taxpayer would not be treated as being entitled to receive (thus, constructively receive) any amount as reimbursement for storage until such amount is actually received.

2. Social Security Act

Under the bill, income from the sale or exchange of any PIK commodity is treated as income for the trade or business of farming. Therefore, such income is subject to the tax on net earnings from self-employment.

3. Treatment of PIK Payment for Other Tax Purposes

Under the bill, for all purposes of the Internal Revenue Code, income from the sale or exchange of PIK commodities is treated as income from the trade or business of farming and the taxpayer is treated as using in the trade or business of farming any land diverted from production under any certified payment-in-kind program. Thus, income with respect to the sale or exchange of commodities received under a certified payment-in-kind program would be treated as gross income from farming for all purposes of the Code, including the requirement for estimated tax payments; determining the proper method of accounting for farming corporations and others; determining the deductibility of certain soil and water conservation expenditures; determining the deductibility of expenditures by farmers for amounts to enrich, neutralize, or condition the land; determining the deductibility of expenditures by farmers for clearing land; determining whether or not an activity is one engaged in for profit; determining whether or not any recapture is owing with respect to the disposition of farming property; and for determining the amount (if any) of the passive income earned by any corporation during the three taxable years before an election by such corporation to be taxed under subchapter S. In addition, income received in respect to marketing commmodities received under any certified payment-in-kind program would be treated as income from a nonpassive source for determining the limitation for the deduction of investment interest; the imposition of the tax on unrelated business income to charitable organizations; and the imposition of the personal holding company tax.

4. Taxation of Cooperatives

Under the bill, income derived by a cooperative (whether exempt or non-exempt) from marketing any commodity received as a payment-in-kind under a certified payment-in-kind program by a member or patron of the cooperative and sold or assigned to the cooperative would be treated as patronage source income from the sale or other disposition of comodities produced by the patron participating in the program. In addition, if a cooperative (whether exempt or non-exempt) received a payment-in-kind under a certified payment-in-kind program directly from the Commodity Credit Corporation (CCC) on behalf of a member or patron because the member or patron had assigned his right to receive the payment to the cooperative, or because the member or patron was required to receive the payment through his cooperative, then the proceeds of the sale or other disposition of such commodities will also be treated as patronage source income from the marketing of a commodity produced by the member-participant.

Thus, income received with respect to the marketing of

PIK commodities would be deductible to both exempt and nonexempt cooperatives. Further, the tax status of exempt farmers' cooperatives would not be endangered by marketing PIK commodities.

Under the bill, if a cooperative has a CCC loan outstanding, and is required, as a condition to its participation in the PIK program, to pay off all or a portion of such loan and then sell the commodity which had been pledged as security for that loan back to the CCC for the same amount as the loan pay-off, the characteristic of the gain realized on such sale or other disposition will be determined with reference to the character, as patronage source or non-patronage source, of the commodity which is sold. Also, as with farmer-participants, the transaction will be treated as a closing-out of the loan and not a discharge of indebtedness.

As is the case with farmer-participants, storage fee reimbursements received by cash basis cooperatives will not be taxable until actually received.

5. Estate Tax Treatment of Farmers

Current use valuation

S. 527 would provide that, for purposes of the current use valuation provision, real property withdrawn from production under a payment-in-kind (PIK) program would be treated as used in an active farming (i.e., "qualified") use during a continuous period not exceeding three years from the time the real property was first withdrawn from production under a PIK program. This treatment would apply for the following purposes:

(1) Determining whether the real property was used in a qualified use for periods aggregating at least 5 years of the 8-year period ending on the date of the decedent's death;

(2) Determining whether the real property was used in a qualified use on the decedent's date of death; and

(3) Determining whether the real property was used in a qualified use during the post-death recapture period.

The bill would also provide that the material participation requirements of the current use valuation provision are deemed to have been satisfied by the recipients of commodities under a PIK program. (See above for a discussion of the treatment of these payments-in-kind for self-employment tax purposes.)

Installment payment of estate tax

S. 527 would provide that, for purposes of the estate tax installment payment provision, real property otherwise used in an active trade or business would not be treated as withdrawn or diverted from the active business use by reason of its withdrawal from production under a PIK program.

Effective date

The estate tax provisions of the bill would apply to real property diverted from production under a PIK program in exchange for commodities received after December 31, 1982, and before April 1, 1986.

VI. Prior Congressional Action on the PIK Program

On February 23, 1983, the Subcommittee on Select Revenue Measures of the Committee on Ways and Means ordered reported to the full committee a bill, H.R. 1296, with amendments, addressing the tax issues arising from the PIK Program and another matter.

A. PIK Tax Treatment Provisions

Under the subcommittee amendment, recognition of income from commodities received in the 1983 PIK Program would be deferred from the date the commodities are received (or constructively received) until the date on which the commodities are sold.

Real property withdrawn from production in exchange for a payment-in-kind under the 1983 PIK Program would be treated as used in an active farming (e.g., qualified) use by the person entering the PIK contract for purposes of the estate tax current use valuation and installment payment provisions. Additionally, an individual who materially participates in the conservation use to which real property withdrawn from production under the 1983 PIK Program is devoted would be treated as materially participating in a farming operation in which the PIK property is used.

The subcommittee bill generally would treat income from PIK commodities as active income derived from the business of farming for all other purposes under the Internal Revenue Code.

For purposes of the self-employment income (SECA) tax and the social security benefit provisions, income from PIK commodities would be treated as "earned" income to persons who materially participate in the conservation use to which the PIK real property is devoted.

Rules would be provided treating commodities received under a PIK program by a cooperative as patronage source income from the sale of commodities produced by the cooperative's patrons.

The subcommittee amendment also includes a special anti-speculation rule that limits the income and estate tax provisions to land acquired by any person before February 24, 1983, unless the acquisition occurs by reason of death, by reason of gift, or from a member of the transferee's family. Mere changes in form are not treated as transfers if the transferor retains at least a direct or indirect 80-percent interest in the land. Under this rule, acquisition of an

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80-percent or more interest in a crop from any land is treated as acquisition of the land.

Finally, a study of the effects of the PIK program and the tax treatment under the bill would be required from the Secretary of the Treasury no later than September 1, 1983.

The income tax provisions of the bill would apply to PIK payments for the 1983 crop year, including PIK payments for crops normally planted before December 31, 1983. The estate tax provisions would apply to real property withdrawn from production in respect of such crops.

B. Exemption of Certain Agricultural Organizations

The subcommittee amendment would exempt from tax certain agricultural organizations operated on a nonprofit basis primarily for collectively bargaining with respect to unprocessed agricultural commodities produced by their members, effective for taxable years beginning after December 31, 1983.

LEGISLATIVE ISSUES IN PROPOSALS AFFECTING THE TAX TREATMENT OF COMMODITIES RECEIVED UNDER THE PAYMENT-IN-KIND (PIK) PROGRAM

ISSUE	PRESENT LAW	PROPOSED ALTERNATIVE
1. Timing of Income	For cash basis taxpayers, income is recognized when actually or constructively received. Accrual method taxpayers recognize income when all events have occurred that fix the right to receive the income and the amount can be reasonably estimated. Under present law, PIK payments will be recognized as income on the date they are made available to farmers.	Recognition of income from PIK payments in a 1983 PIK program would be deferred from the date the commodities are received (or constructively received) to the date they are sold by the farmer. An anti-speculation rule would limit the deferral of income provisions to property owned on February 23, 1983, or to property inherited or acquired by gift from an individual who owned it on February 23, 1983.
2. Current Use Valuation for Estate Tax Purposes	Real property to be specially valued must be used in an active farming use for 5 years of the 8-year period before a decedent's death and on the date of death. Qualified heirs must use specially valued property in an active farming use throughout a prescribed period to avoid imposition of a recapture tax. An individual is treated as using property in farming only if the individual is at risk as to price and production.	Real property withdrawn from production in exchange for a payment-in-kind under the 1983 PIK program would be treated as used in an active farming operation in which the person entering the PIK contract was at risk.

ISSUE	PRESENT LAW	PROPOSED ALTERNATIVE
	Only property with respect to which material participation requirements are satisfied is eligible for current use valuation. These requirements apply to both the pre-death and recapture period.	An individual who materially participates in the conservation use to which property withdrawn from production under the PIK program is put is considered to satisfy the current use valuation material participation requirement. An anti-speculation rule would limit the estate tax provisions to property owned on February 23, 1983, or to property inherited or acquired by gift from an individual who owned it on February 23, 1983. Effective date.--These provisions would apply to land withdrawn from production during the 1983 crop year pursuant to the 1983 PIK program.

ISSUE	PRESENT LAW	PROPOSED ALTERNATIVE
3. Payments of Estimated Tax	Persons whose estimated gross income from farming is at least two-thirds of their total estimated gross income are not required to pay quarterly installments of estimated tax if their returns are filed and tax is paid in full by March 1. No underpayment penalty will be imposed if estimated tax payments are at least 66-2/3 percent of the tax for the year.	Commodities received under a 1983 PIK program would be treated as gross income from farming.
4. Method of Accounting by Corporations Engaged in Farming	Farming corporations, other than certain "family-owned" and other small corporations must use accrual accounting. These small corporations may use the cash method.	Commodities received under a 1983 PIK program would be treated as income from farming.
5. Soil and Water Conservation Expenditures	Taxpayers engaged in the trade or business of farming can elect to expense certain amounts which are paid or incurred for the purpose of soil or water conservation with respect to land used for farming.	Property withdrawn from production under a 1983 PIK program would be treated as used by the taxpayer in the trade or business of farming; commodities received under a 1983 PIK program would be treated as income from farming,

ISSUE	PRESENT LAW	PROPOSED ALTERNATIVE
6. Expenditures by Farmers for Fertilizer, etc.	Taxpayers engaged in the trade or business of farming may elect to expense amounts otherwise chargeable to capital account which are paid to enrich, neutralize, or condition land used in farming.	Property withdrawn from production under a 1983 PIK program would be treated as used by the taxpayer in the trade or business of farming.
7. Expenditures by Farmers for Clearing Land	Taxpayers engaged in farming may elect to deduct currently expenditures, subject to certain limitations, for clearing land.	A taxpayer receiving commodities under a 1983 PIK program would be treated as engaged in the business of farming with respect to land withdrawn from production under the 1983 PIK program.
8. Activities not Engaged in for Profit	If an individual or subchapter S corporation engages in an activity not for profit, generally no deductions in excess of the income attributable to such activity are allowed.	A taxpayer receiving commodities under a 1983 PIK program would not be treated as not engaged in an activity for profit solely by reason of participation in the PIK program.
9. Gain from Disposition of Property Used in Farming or Farm Losses Offsetting Farm Income	Taxpayers are prevented from taking ordinary loss deductions attributable to farming with respect to pre-1976 taxable years and then selling the farm property at capital gain rates.	Commodities received under a 1983 PIK program would be treated as gross income from farming.

ISSUE	PRESENT LAW	PROPOSED ALTERNATIVE
10. Qualification of Corporations for Subchapter S Status	For corporations which had accumulated earnings and profits before electing subchapter S status, passive income within the 3 taxable years before such election cannot exceed 25 percent of gross receipts.	Commodities received under a 1983 PIK program would not be treated as passive income in determining a corporation's eligibility for subchapter S status.
11. Self-Employment Income	Earned income is subject to self-employment income (SECA) tax. An individual's farm income is "earned" for SECA purposes if the individual materially participates in the farm operation.	Commodities received under a 1983 PIK program would be treated as earned income for SECA tax purposes.
	Present law provides for reduction of social security benefits payable to individuals below age 70 if the individual's earned income exceeds a prescribed amount.	Commodities received under a 1983 PIK program would be treated as earned income for social security benefit purposes.

ISSUE	PRESENT LAW	PROPOSED ALTERNATIVE
12. Tax Treatment of Payments-In-Kind Marketed Through Co-operatives	Cooperatives (both exempt and non-exempt) are allowed to exclude from income amounts paid to members or patrons as patronage dividends or per-unit retain allocations, where such amounts are earned from marketing commodities produced by members or patrons. Such payments are includible in the income of the member or patron when paid or allocated.	1. The Secretary of the Treasury or his delegate (after consultation with the Secretary of Agriculture) could be granted authority to prescribe such regulations as may be necessary to carry out the purposes of this Act. These regulations would provide that: a. Income from marketing commodities received under a 1983 PIK program is treated as patronage source income deductible to the cooperative (this rule would also protect the exemption of exempt farmers' cooperatives), regardless of whether the cooperative receives the commodity from the taxpayer or from the Commodity Credit Corporation on behalf of the taxpayer.

ISSUE	PRESENT LAW	PROPOSED ALTERNATIVE
		b. Amounts received directly by a cooperative under the 1983 PIK program (e.g., rice and cotton cooperatives) would be treated as received on behalf of the member or patron signing the PIK contract.
13. Installment Payment of Estate Tax	Estate tax attributable to the value of an interest in a closely held business can be deferred and paid over up to 14 years if certain requirements are satisfied. Only interests in active businesses, as opposed to passive investments, are eligible for the installment payment provision.	Real property withdrawn from production in exchange for a payment-in-kind under a 1983 PIK Program would be treated as used in the active conduct of farming. An anti-speculation rule would limit the estate tax provisions to property owned on February 23, 1983, or to property inherited or acquired by gift from an individual who owned it on February 23, 1983.
14. Definition of 1983 PIK Program		For purposes of the proposed alternative, crops that would have been planted before December 31, 1983, will be treated as a 1983 crop.

ISSUE	PRESENT LAW	PROPOSED ALTERNATIVE
15. Require study on who getting what		The Treasury Department (in consultation with USDA) would be required to submit a study on the effects of the PIK program and the proposed alternative.

98TH CONGRESS
1ST SESSION

S. 446

To amend the Internal Revenue Code of 1954 with respect to the tax treatment of agricultural commodities received under a payment-in-kind program.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 3 (legislative day, JANUARY 25), 1983

Mr. JEPSEN (for himself, Mr. DOLE, and Mr. GRASSLEY) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 with respect to the tax treatment of agricultural commodities received under a payment-in-kind program.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 451 of the Internal Revenue Code of 1954 (relating to general rule for taxable year of inclusion) is amended by adding at the end thereof the following new subsection:

"(f) SPECIAL RULE FOR AGRICULTURAL COMMODITIES RECEIVED UNDER A CERTIFIED PAYMENT-IN-KIND PROGRAM.—

"(1) IN GENERAL.—In the case of a taxpayer who receives any commodity under a certified payment-in-kind program—

"(A) no income shall be treated as realized by reason of receipt of such commodity, but

"(B) there shall be included in gross income the amount of any gain from the sale or exchange of such commodity.

"(2) SPECIAL RULES FOR DETERMINING AMOUNT OF GAIN, ETC.—In the case of any sale or exchange of any commodity received under a certified payment-in-kind program—

"(A) in determining the amount of gain from such sale or exchange—

"(i) the taxpayer shall be treated as having a zero basis in such commodity, and

"(ii) such gain shall be treated as ordinary income, and

"(B) the taxable year in which gain from such sale or exchange is included shall be determined under the taxpayer's method of accounting for the taxable year in which such sale or exchange occurs.

"(3) CERTIFIED PAYMENT-IN-KIND PROGRAM.—The term 'certified payment-in-kind program' means any program—

"(A) under which the Secretary of Agriculture or his delegate makes payments in kind of any agricultural commodity to any producer of agricultural commodities who—

"(i) diverts farm acreage from the production of an agricultural commodity, and

"(ii) devotes such acreage to conservation uses, and

"(B) which the Secretary of Agriculture certifies to the Secretary of the Treasury as being described in subparagraph (A).".

(b) The amendment made by this section shall apply to taxable years beginning after December 31, 1982.

SEC. 2. (a) Section 2032A(e) of the Internal Revenue Code of 1954 (relating to special rules for valuation of certain farm, etc., real property) is amended by adding at the end thereof the following new paragraph:

"(15) TREATMENT OF PAYMENTS RECEIVED UNDER A CERTIFIED PAYMENT-IN-KIND PROGRAM.—For purposes of this section, any commodity received by, or on behalf of, any person under a certified payment-in-kind program (within the meaning of section

451(f)(3)) shall be treated as a commodity produced by such person on acreage diverted from agricultural use under such program.".

(b) The amendment made by this section shall apply to estates of decedents dying after December 31, 1976.

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II

98TH CONGRESS
1ST SESSION

S. 495

To amend the Internal Revenue Code of 1954 to allow any taxpayer to elect to treat for income tax purposes any crop received under a Federal program for removing land from agricultural production as produced by the taxpayer, to allow any taxpayer to elect to defer income on any cancellation under such a program of any price-support loan, and to provide that participation in such a program shall not disqualify the taxpayer for the special use valuation of farm real property under section 2032A of such Code.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 16 (legislative day, FEBRUARY 14), 1983

Mr. BAUCUS introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to allow any taxpayer to elect to treat for income tax purposes any crop received under a Federal program for removing land from agricultural production as produced by the taxpayer, to allow any taxpayer to elect to defer income on any cancellation under such a program of any price-support loan, and to provide that participation in such a program shall not disqualify the taxpayer for the special use valuation of farm real property under section 2032A of such Code.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. ELECTION TO TREAT CROP AS PRODUCED BY THE TAXPAYER; ELECTION TO DEFER INCOME ON CANCELLATION OF PRICE-SUPPORT LOANS MADE BY COMMODITY CREDIT CORPORATION.

(a) IN GENERAL.—Section 451 of the Internal Revenue Code of 1954 (relating to general rule for taxable year of inclusion) is amended by adding at the end thereof the following new subsection:

"(f) PAYMENTS IN KIND, AND LOAN CANCELLATIONS, FOR REMOVING LAND FROM AGRICULTURAL PRODUCTION.—

"(1) PAYMENTS IN KIND.—If any amount would (but for this subsection) be includible in the gross income of the taxpayer for the taxable year by reason of the receipt of any agricultural commodity under a qualified Federal farmland removal program, the taxpayer may elect, in lieu of including such amount in income at the time of such receipt, to treat such commodity as if it were produced by the taxpayer, except that the unadjusted basis of such commodity in the hands of the taxpayer shall be zero.

"(2) CANCELLATION OF LOAN.—

"(A) IN GENERAL.—If any amount would (but for this subsection) be includible in the gross income of the taxpayer for the taxable year by reason of the cancellation under a qualified Feder-

al farmland removal program of any qualified price-support loan, the taxpayer may elect, in lieu of including such amount in income for such year, to include in each taxable year such year's proportionate share of the income from such cancellation.

"(B) YEAR'S PROPORTIONATE SHARE OF INCOME.—For purposes of subparagraph (A), a year's proportionate share of income from cancellation of a loan is an amount which bears the same ratio to the total income from the cancellation of such loan as the amount of the agricultural commodity which secured such loan and which is disposed of (or consumed) during such year bears to the total amount of the agricultural commodity which secured such loan.

"(3) DEFINITIONS.—For purposes of this subsection—

"(A) QUALIFIED FEDERAL FARMLAND REMOVAL PROGRAM.—The term 'qualified Federal farmland removal program' means any Federal program for removing land from agricultural production.

"(B) QUALIFIED PRICE-SUPPORT LOAN.—The term 'qualified price-support loan' means any

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loan made under the Agricultural Act of 1949 to support the price of any agricultural commodity.

"(C) AGRICULTURAL COMMODITY.—The term 'agricultural commodity' includes any interest therein.

"(4) ELECTIONS.—Any election under this subsection—

"(A) may be made separately with respect to each receipt of a commodity and each loan canceled, and

"(B) shall be made at such time and in such manner as the Secretary may prescribe by regulations.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years ending after December 31, 1982.

SEC. 2. COORDINATION WITH ESTATE TAX TREATMENT OF PROPERTY USED AS A FARM FOR FARMING PURPOSES.

(a) IN GENERAL.—Subsection (e) of section 2032A of the Internal Revenue Code of 1954 (relating to valuation of certain farm, etc., real property) is amended by adding at the end thereof the following new paragraph:

"(15) PAYMENTS IN KIND, AND LOAN CANCELLATIONS, UNDER QUALIFIED FEDERAL FARMLAND

REMOVAL PROGRAMS.—Nothing in this section shall be construed to prevent—

"(A) property from being treated as used as a farm for farming purposes, and

"(B) any individual from being treated as materially participating in the operation of the farm with respect to any property,

for any period merely because during such period, in lieu of producing a crop, such property was removed from production pursuant to a qualified Federal farmland removal program (within the meaning of section 451(f)(3)(A)).".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to estates of decedents dying after December 31, 1982.

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II

98TH CONGRESS
1ST SESSION

S. 527

To amend the Internal Revenue Code of 1954 with respect to the tax treatment of agricultural commodities received under a payment in kind program.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 17 (legislative day, FEBRUARY 14), 1983

Mr. GRASSLEY (for himself, Mr. WALLOP, Mr. BENTSEN, Mr. BOREN, Mr. SYMMS, Mr. KASTEN, and Mr. ROTH) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 with respect to the tax treatment of agricultural commodities received under a payment in kind program.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Payment In Kind Tax Clarification Act of 1983".

SEC. 2. TREATMENT OF INCOME FROM COMMODITIES RECEIVED UNDER PIK PROGRAMS.

Section 451 of the Internal Revenue Code of 1954 (relating to general rule for taxable year of inclusion) is amended by adding at the end thereof the following new subsection:

"(f) SPECIAL RULES FOR AGRICULTURAL COMMODITIES RECEIVED UNDER A CERTIFIED PAYMENT IN KIND PROGRAM.—

"(1) IN GENERAL.—In the case of a taxpayer who receives, or is entitled to receive, any commodity under a certified payment in kind program—

"(A) no income shall be treated as realized by reason of such receipt or entitlement, but

"(B) there shall be included in gross income the amount of any gain from the sale or exchange of such commodity.

"(2) SPECIAL RULES FOR DETERMINING AMOUNT AND CHARACTER OF GAIN, ETC.—In the case of any commodity which a taxpayer receives, or is entitled to receive, under a certified payment in kind program—

"(A) The cost basis of such commodity for purposes of section 1012 shall be zero.

"(B) For purposes of determining the character of gain (if any) from the sale or exchange of—

"(i) such commodity, or

"(ii) any property the basis of which is determined by reference to the basis of such commodity,

such commodity shall be treated as produced by the taxpayer.

"(C) For purposes of this title and the Social Security Act—

"(i) any income from the sale or exchange of such commodity shall be treated as income from the trade or business of farming, and

"(ii) the taxpayer shall be treated as being engaged in the trade or business of farming with respect to any property diverted from use in the trade or business of farming under such certified payment in kind program.

"(3) SPECIAL RULES FOR CERTIFIED PAYMENT IN KIND PROGRAMS INVOLVING REPAYMENT OF COMMODITY CREDIT LOANS.—

"(A) APPLICATION OF PARAGRAPH.—The rules of subparagraph (B) shall apply in any case in which any certified payment in kind program involves—

"(i) the repayment by the taxpayer of a loan from the Commodity Credit Corporation,

"(ii) the purchase by the Commodity Credit Corporation of the commodity securing the loan described in subparagraph (A), and

"(iii) the receipt (or entitlement to receipt) of such commodity by the taxpayer after such purchase as a payment in kind under such certified program.

"(B) RULES OF APPLICATION.—The rules of this subparagraph are as follows:

"(i) This subsection shall apply only to the transaction described in subparagraph (A)(iii) (and without regard to the transactions described in clause (i) or (ii) of subparagraph (A)).

"(ii) In the case of the transactions described in clause (i) or (ii) of subparagraph (A), such transactions shall—

"(I) in the case of a taxpayer who made an election under section 77 with respect to the loan, be treated as trans-

actions closing the sale of the commodity to which section 77 applied, and

"(II) in the case of any other taxpayer, be treated as a sale of such commodity.

"(4) AMOUNTS RECEIVED BY THE TAXPAYER AS REIMBURSEMENT FOR STORAGE.—A taxpayer reporting on the cash receipts and disbursement method of accounting shall not be treated as being entitled to receive any amount as reimbursement for storage of commodities received by the taxpayer under a certified payment in kind program until such amount is actually received by the taxpayer.

"(5) CERTIFIED PAYMENT IN KIND PROGRAM.—The term 'certified payment in kind program' means any program—

"(A) under which the Secretary of Agriculture or his delegate makes payments in kind of any agricultural commodity to any producer of agricultural commodities who—

"(i) diverts farm acreage from the production of an agricultural commodity, and

"(ii) devotes such acreage to conservation uses, and

"(B) which the Secretary of Agriculture certifies to the Secretary of the Treasury as being described in subparagraph (A).".

SEC. 3. ESTATE TAX PROVISIONS.

(a) SPECIAL USE PROVISIONS.—

(1) QUALIFIED REAL PROPERTY.—Subsection (b) of section 2032A of the Internal Revenue Code of 1954 (defining qualified real property) is amended by adding at the end thereof the following new paragraph:

"(6) TREATMENT OF PROPERTY DIVERTED FROM FARM USE UNDER A CERTIFIED PAYMENT IN KIND PROGRAM.—For purposes of determining whether the requirements of paragraph (1) are met with respect to any real property, such property shall be treated as used for a qualified use during the period—

"(A) beginning on the first day on which such property is diverted by the decedent or members of the decedent's family from use for a farming purpose under a certified payment in kind program (within the meaning of section 451(f)(5)), and

"(B) ending on the earlier of—

"(i) the date which is 3 years after the date described in subparagraph (A), or

"(ii) the first date on which such property ceases to be so diverted by the decedent or members of the decedent's family under such program.".

(2) CESSATION OF USE.—Subsection (c) of section 2032A of such Code (relating to tax treatment of dispositions and failures to use for qualified use) is amended by adding at the end thereof the following new paragraph:

"(8) SPECIAL RULES FOR CESSATION OF USE UNDER A CERTIFIED PAYMENT IN KIND PROGRAM.—A qualified heir shall not be treated for purposes of this subsection as ceasing to use real property for a qualified use during the period—

"(A) beginning on the first day on which such property is diverted by the qualified heir from use for a farming purpose under a certified payment in kind program (within the meaning of section 451(f)(5)), and

"(B) ending on the earlier of—

"(i) the date which is 3 years after the date described in subparagraph (A), or

"(ii) the first date on which such property ceases to be so diverted by the qualified heir under such program.".

(b) EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX.—Subsection (g) of section 6166 of the Internal Revenue Code of 1954 (relating to acceleration of payment) is amended by adding at the end thereof the following new paragraph:

"(4) SPECIAL RULE FOR PROPERTY DIVERTED FROM USE UNDER A PAYMENT IN KIND PROGRAM.—For purposes of paragraph (1), property which is used in the trade or business of farming shall not be treated as withdrawn from such trade or business if such property is diverted from use for farming purposes solely by reason of participation in a certified payment in kind program (within the meaning of section 451(f)(5)).".

SEC. 4. COOPERATIVES.

(a) COOPERATIVES EXEMPT FROM TAX.—Subsection (b) of section 521 of the Internal Revenue Code of 1954 (relating to applicable rules for tax-exempt farmers' cooperatives) is amended by adding at the end thereof the following new paragraph:

"(6) SPECIAL RULE FOR PAYMENT IN KIND COMMODITIES.—If any cooperative markets any commodity received by, or on behalf of, a member under a certified payment in kind program (within the meaning of section 451(f)(5)), the cooperative shall be treated as marketing the product of such member.".

(b) COOPERATIVES AND PATRONS.—Section 1388 (relating to definitions and special rules) is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

"(j) SPECIAL RULE FOR PAYMENT IN KIND COMMODITIES.—For purposes of this chapter, if any cooperative markets any commodity received by, or on behalf of, a patron under a certified payment in kind program (within the meaning of section 451(f)(5)), the cooperative shall be treated as marketing the product of such patron.".

SEC. 5. EFFECTIVE DATE.

(a) IN GENERAL.—Except as provided in this section, the amendments made by this Act shall apply to commodities received under a certified payment in kind program (within the meaning of section 451(f)(5) of the Internal Revenue Code of 1954) after December 31, 1982, and before April 1, 1986.

(b) ESTATE TAX PROVISIONS.—The amendments made by section 3 shall apply to real property diverted from agricultural use under a certified payment in kind program (as so defined) by reason of commodities received under such program after December 31, 1982, and before April 1, 1986.

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The PIK program, as designed by the U.S. Department of Agriculture, is essentially a crop surplus liquidation and farm acreage reduction program. If the program is successful, the present commodity surplus and additions to that surplus will be reduced.

Under the rules of supply and demand as I learned them, if current supplies are reduced to bring them closer in line with demand, then the asking price for those supplies must rise, and rise they must. In my home State of Wyoming, farm income has fallen from $106 million in 1979 to a little more than $1 million in 1981, or about $118 for each of the State's farms and ranches operating in 1981.

In one respect, the administration's PIK proposal has been very successful. In what may be considered more a tribute to the present complexities of the Tax Code than the creativity of USDA, the PIK program has successfully created questions and issues about section after section of the Tax Code.

The seriousness of those issues must not be underestimated, and a quick resolution may be key to the success of the program. One of the questions raised by the PIK program concerns the income tax treatment for farmers who participate in it. That particular question has matured into a very specific problem under the doctrine of "constructive receipt." Compensation must be brought into income when it is available for the taxpayer to draw upon.

Under the present law, the IRS has little choice but to require the farmer take the PIK crop into income when the farmer has the right to receive it. That prospect has created reluctance in the agricultural community to participate in the PIK program and has raised the issue of whether as a matter of fairness that crop should be treated as grown by the farmer and thus taxed when the farmer disposes of the crop.

It is my opinion and that of many of my colleagues that a farmer should not be forced into an adverse tax situation as a result of participation in a Government program designed to encourage that farmer to take acreage out of production.

As much a problem but less a question in my mind are the estate tax ramifications of participation in the PIK program. Specifically, the issue has been raised that if a farmer participates in the PIK program, should the acreage set aside because of that participation continue to qualify under the material participation and qualified use requirements of the current use valuation provision of the estate tax law?

There is no question, in my opinion, nor should there be one in the Tax Code, that when a farmer participates in an acreage set-aside program sponsored by the Federal Government, that the land set aside should continue to qualify for the current use valuation. It is my hope and understanding that the Treasury Department agrees with me in that view.

Other problems with respect to the tax treatment of farm cooperatives and technical questions concerning several other sections of the Tax Code have been raised. It is the purpose of this hearing to identify all of the tax problems related to the PIK program and to seek alternatives which address and resolve those problems.

To that end, three bills have been introduced in the Senate by Senator Jepsen, Senator Baucus, and Senator Grassley and myself.

All three bills will be addressed during the course of this hearing. It is also my understanding that Congressman Stark's subcommittee of the House Ways and Means Committee has marked up a PIK tax bill and will be reporting its recommendation to the full Ways and Means Committee very soon.

From the descriptions of the Ways and Means bills I have seen, their product is very close to the legislation introduced earlier by Senator Grassley and me. I do have some questions regarding some of the restrictions included in the Ways and Means bill, but I believe they are to be complimented for their speedy action.

In conclusion, I would like also to compliment my Senate colleagues who have recognized the need to move quickly in resolving the tax issues raised by the PIK program and look forward to their participation in this hearing.

Senator Grassley, did you have an opening statement?

Senator GRASSLEY. I think you have laid out very well what the problem is. I am just going to insert my statement in the record at this point and let it go at that, except to just say that as long as there is some doubt in people's minds that we are going to pass a bill, I think we should assume it will have a negative impact on the signup on PIK.

We don't want anything like this to have a negative impact on the signup of PIK. PIK is such an important program and it is the most ideal solution to the farm problem we have before us of overhang on the market, so farmer participation is very important to get the overhang down and get our farm prices up.

So I would say ideally if we could get this bill passed and signed by the President by March 11, that would be the best thing to do. If that will not be possible because evidently the House cannot take it up until a week from Tuesday because that is their suspension day there, and it is my understanding they want to take it up under suspension, that at least it be moving so far along, as far as the House and Senate is concerned, that there will be no doubt in any farmer's mind that we are intent upon passing this legislation so that any doubts he has as to the handling of the income from PIK, that those will be answered and they will not stand in the way of his cooperation.

I think we can move along that far. I think this hearing today under your leadership—and thank you for inviting my subcommittee to participate in this—is a step in that direction.

Senator WALLOP. Thank you, Senator Grassley. Thank you very much for the cooperation we have had from your office in trying to put this thing together for each of our States and purposes.

[The prepared statement of Senator Grassley follows:]

PREPARED STATEMENT OF SENATOR CHARLES E. GRASSLEY

Thank you, Chairman Wallop. I would like to thank you for inviting the Subcommittee on Oversight of the Internal Revenue Service to hold these hearings with you on this topic of great importance to agricultural states. All of my colleagues here today are aware of the critical condition of the farm economy.

Net farm income dropped steadily from $26.7 billion in 1979 to $24.4 billion in 1980 and down from $19.6 billion in 1981. Last year's net farm income rose slightly to $20.4 billion, but these figures must be viewed in light of a steady yearly upward trend in farm production costs during the past three decades.

The high cost of production and oversupply of commodities have created this serious situation. During the last two years, production of grains, oilseeds, and cotton have reached record levels, far surpassing world demand. High interest rates, the international recession, a strong U.S. dollar, the Soviet grain embargo, and subsidized crops of our competitors have contributed to weakened worldwide demand for U.S. agricultural products. As our markets remain soft, domestic production continues its dramatic increase.

To address these converging problems, the Reagan Administration developed the Payment in Kind program (PIK). PIK participants will receive government-owned grain if they remove their corn, sorghum, wheat, cotton or rice acreage from production. The goal of this program is to stablize and improve market prices by reducing production and surplus stocks. An additional benefit will be reduced government costs for farm programs and grain storage from prior farm programs.

USDA predicts the PIK program can reduce acreage planted by 23 million acres. Production and ending stocks of wheat and feed grains are expected to fall by one billion bushels. Some economists estimate that corn stocks alone could be reduced by ½ billion bushels to bring ending stocks to around 2.8 billion bushels. These same economists predict that strong participation in the PIK program could raise corn prices by 20 cents per bushel above the otherwise expected price of $2.25 to $2.30 per bushel. With a successful PIK program, prices could rise as hight as $2.90 per bushel by 1984. The impact of this price increase on my constituents and individuals throughout the midwest would be profound.

PIK offers real hope in helping rebuild the farm economy in 1983, but large PIK participation will be necessary to stabilize agricultural prices and reduce surplus stock. The success of the PIK program is being threatened by the spectre of adverse tax consequences for PIK participants. If current law is unchanged, a farmer who has the right to receive a commodity under the PIK program must take the fair market value of the corn into income under the doctrine of constructive receipt. Consequently, a farmer who has enrolled in the PIK program for this 1983 crop faces the possibility of paying tax on his 1983 crop when he has the right to receive the commodity (which in the case of corn is October 1982) and his 1982 crop if he has deferred the sale of the crop until 1983. The possibility of recognizing income from two crop years in a single year has dissuaded many farmers from entering the PIK program. Also, a farmer's estate tax planning can be altered with PIK participation because there is some question as to whether or not land in the PIK program is farmed as a qualified use for special use valuation purposes. These issues arise for both decedents and heirs, since this code section requires both generations to be engaged in the active trade or business of farming. Additional tax difficulties emerge when a co-operative attempts to market PIK grain. Also, the tax treatment of PIK storage payments is in question since current law would require the farmer to recognize these payments in the year when he has the right to receive this income.

Senator Wallop and I introduced a comprehensive bill designed to address these issues. Senator Dole and Senator Jepsen introduced an earlier bill focusing the agricultural community's attention on these important topics. Senator Baucus has adopted a slightly different approach which achieves many of the same goals all of us wish to attain. Our colleagues in the House of Representatives have marked up a measure which closely parallels S. 527, except it sunsets after one year rather than after two years as provided in our bill. I am very grateful to the members of the Committee on Ways and Means and their able staffs for addressing this problem so quickly. The Subcommittee on Select Revenue Measures marked up this bill last Wednesday; full Committee markup is scheduled at 2:00 p.m. tomorrow.

The comments of the witnesses on the respective bills before us will be very helpful. Our goal is to report a measure which is identical or very similar to the House bill to avoid a Conference. Given the March 11th enrollment deadline for the PIK program, dispensing with the requirement of a Conference Committee is desirable if the program is to be a success. Consequently, your comments on the House measure will be particularly valuable to us as we progress through the legislative process.

Thank you.

Senator WALLOP. Senator Dole.

Senator DOLE. I just have a statement to put in the record along with a letter submitted to Roscoe Egger, the Commissioner, with reference to the estate tax problem. I think that could probably be handled without legislation, but again, we need to move very quickly on this.

It is our hope to mark it up Wednesday in the full committee, and I would encourage my colleagues not to look at this as a vehicle for a lot of amendments.

If we have a lot of amendments to it, I am told by the Chairman of the Ways and Means Committee to forget it. But I do want to commend the House for moving it quickly, and I think they will get a bill over here as quickly as they can. If it is in good form when it comes, we can just stop it at the desk and pass it because Senator Grassley, Senator Wallop and others have put their finger on it: We must let the farmer know by March 11 that this is going to become law. Otherwise, they may not participate, and we do not want to discourage participation.

[The prepared statement of Senator Dole follows:]

PREPARED STATEMENT OF SENATOR BOB DOLE

INTRODUCTION

I am very pleased that the Chairman of the Subcommittee on Energy and Agricultural Taxation, Senator Malcolm Wallop, and the Chariman of the IRS Oversight Subcommittee, Senator Charles E. Grassley, scheduled this early hearing on legislation to resolve a number of Federal tax problems that have arisen under the administration's Payment-In-Kind Program.

The success of the administration's Payment-In-Kind or "PIK" Program is of the greatest importance to this nation's farmers. Judging from initial reports on registration for the program, PIK could well have a price-enhancing effect for cotton and rice producers, and could hold the line against any deterioration of crop values during the 1983 wheat and feed grain harvests.

PIK TAX PROBLEMS

The PIK Program is designed to give farmers surplus grain and other commodities in return for their agreement to withdraw farmland from active production, and devote that farmland to a conservation use. The tax problems that may discourage some farmers from participating in this program arise from the fact that the tax law generally treats a farmer growing crops differently from a farmer who receives and sells crops that he did not actually grow. Several bills have been introduced in both the Senate and the House which are intended to treat the recipient of a PIK crop payment as if he had actually grown the crop, for purposes of Federal income and estate taxes. Enactment of such legislation will not only embody sound tax policy, but will also be of invaluable assistance to the Administration's efforts to encourage participation in this important program.

ISSUES NOT REQUIRING LEGISLATION

It is particularly appropriate that this hearing is convened jointly by the Subcommittee on Energy and Agricultural Taxation and the Subcommittee on Oversight of the IRS, because some of the tax issues require legislative solutions, while others are within the authority of the IRS to resolve by ruling or regulation. The income tax issues addressed by the various PIK bills (including whether income must be recognized immediately upon receipt of a PIK payment) cannot easily be resolved without legislation. In my view, however, the estate tax issues, relating to the special estate tax provisions available for active farm businesses, can be resolved administratively.

Accordingly, I have not only joined in sponsoring and supporting PIK legislation but have also written to IRS Commissioner Roscoe Egger urging him to issue an expedited ruling, clarifying that PIK participation will be treated as if the participants were actively growing crops, for purposes of the estate tax.

I would like to include in the record a copy of the letter I sent to Commissioner Egger on February 22, 1983. Joining me in that letter were Senators Jepsen and

Kassebaum, and the two chairmen of today's hearing, Senators Wallop and Grassley. I wish to thank them for joining me in that ruling request.

WELCOME TO OUR WITNESSES

I look forward to hearing the testimony of our distinguished witnesses on the bills that have been introduced in the Senate to resolve the tax problems, and encourage participation in the program.

Senator WALLOP. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

I also have a formal statement that I would like inserted in the record. Obviously, the main points have already been made. To recap them, farmers soon must decide whether to sign up for the PIK program, but there is a lot of confusion about PIK and about the tax status of PIK. This confusion must be cleared up right away.

Actually, a more important problem is that a lot of farmers don't have any income to pay taxes on anyway. For example, in 1978 Montana farmers' average income was $10,000. Last year it was $32. We eventually must address this problem, too.

Regarding PIK, I think that the bills I and others on this committee have introduced will largely resolve the questions. So, I hope we can achieve one of those bipartisan compromises we often hear the other side talking about.

[The prepared statement of Senator Baucus follows:]

STATEMENT OF SENATOR MAX BAUCUS

Mr. Chairman, I thank Senators Wallop and Grassley for convening this hearing to discuss the urgent matter of tax policy under the Payment-in-Kind (PIK) program.

These are hard times for America's farmers. Many farmers are worried that participating in the PIK program will leave them worse off because of the tax treatment announced by the IRS. For many Montana farmers there is a more critical problem—generating an income to pay taxes on. In 1978, the average net income for a Montana farmer was over $10,000. In 1981 that figure plunged to $32.

I am troubled by several provisions of the PIK program. While the concept is attractive for reducing the surpluses we have piled up over the past several years, there is no relief offered for depressed farm prices in the short run. I hope Congress will make the critical State of our farm economy a number one priority this session.

Nevertheless, today we are addressing the critical issue of tax treatment under the PIK program. I have introduced S. 495 to assure farmers who participate in the PIK program that they will be taxed fairly.

We must act quickly. The signup deadline for the PIK program is March 11—less than 2 weeks away. We must enact a bill that makes clear that PIK commodities can be taxed the same as commodities farmers produce. And we must assure that farmers who participate in land diversion programs like PIK do not endanger their status under section 2032A of the tax code.

I know that the witnesses have been working closely with Congress to accomplish this. I look forward to your testimony.

Senator WALLOP. You have often heard the other side talking about that?

Senator BAUCUS. I have heard about it lately.

Senator WALLOP. I thought I heard your side talking about it.

Senator BAUCUS. Excuse me?

Senator WALLOP. I said I thought I heard your side talking about it.

Senator DOLE. That is the jobs bill. [Laughter.]

Senator WALLOP. Senator Symms.

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Senator SYMMS. Thank you, Mr. Chairman. I would just like to associate myself with the comments my colleagues have made here, and I would like to thank all of you who have worked diligently to bring this before us as rapidly as possible. I hope we can get expeditious action on it and solve the problem.

I think all of us from the farm communities are aware of the problem the farmers are having deciding whether or not to participate, and if it is to work, we must have participation, so I would like to help move it along any way I can.

Senator WALLOP. Senator Symms, I appreciate it. I appreciate the cooperation we have had from all Senators, and I would ask now that statements by Senator Durenberger, Senator Bentsen, Senator Boren, and Senator Pryor be inserted in the record at this point.

[The prepared statements of Senators Durenberger, Bentsen, Boren, and Pryor follow:]

PREPARED STATEMENT OF SENATOR DURENBERGER FOR HEARINGS ON PIK-RELATED TAX PROBLEMS

Let me begin by thanking the Chairmen of the Subcommittees on Energy and Agricultural Taxation and on Oversight of the Internal Revenue Code, my colleagues Senators Wallop and Grassley, for calling this hearing so promptly.

The deadline for sign-up for the PIK program is March 11. The early sign-up indicates that PIK may be very successful. That's good news for farmers whose income is at Depression-era levels and for consumers for whom a strong farm community is a vital step on the road to economic recovery for our entire country. Unless we address the tax problems that arise because of the PIK program, we will be threatening its success. Farmers have told me they've signed up for the program but will drop out by March 11 if the tax problems are not ironed out.

One potential tax problem that has been overlooked until recently is the estate tax treatment of farmland dedicated to the PIK program. Last week a Minnesota farmer told me he doesn't want to participate in the program if it will jeopardize favorable estate tax treatment so he can keep his farm in the family. I assured him that S. 446 and S. 527 would clarify the question and treat land dedicated to the PIK program as "qualified use" for special use valuation purposes.

Many of us recognized the burden of estate taxes on family farms. Two years ago we included long-overdue estate tax reform in the Economic Recovery Tax Act. Certainly, the intend of the PIK program is not to undo the good we did two years ago.

S. 446 and S. 527, which I have co-sponsored, will remedy more than the estate tax problems of farmers who choose to participate in the PIK program. These bills would delay the taxation of PIK commodities until sold or exchanged. They would provide a farmer who has taken a Commodity Credit Corporation loan with the same effective tax treatment as one who had no loan. S. 527 would clarify the tax treatment of PIK commodities sold through co-operatives.

Besides the special use valuation change, S. 527 would make conforming changes in Section 6166 so that the estates of farmers who had participated in the PIK program would still be eligible for extended payment of estate taxes.

There are many changes made by S. 527, and each and every one of them is necessary to make the PIK program effective. I congratulate my colleagues on the Finance Committee for their quick action, and urge Congress to act with the same speed.

The PIK program is important to the recovery of the agricultural economy. Certainly, it is not the only solution to restoring our farm economy and the vitality of our rural communities. It is an innovative, short-term response to the immediate crisis.

However, for the PIK program to be successful, we must act promptly to assure farmers and their families that they will be treated fairly.

Thank you.

PREPARED STATEMENT OF U.S. SENATOR LLOYD BENTSEN

Thank you Mr. Chairman. I have also been deeply concerned about the unintended impact of the tax code on the Payment in Kind program for some time, and as an original sponsor of S. 257, a bill to relieve this tax problem, I urge its immediate enactment.

There can be no doubt that American farmers are in serious trouble. Real net farm income in 1982, according to USDA figures, was only $7.1 billion. This is down 23 percent from 1981, and is only a little more than half the average for the previous decade.

Farm prices are very low for a number of reasons. One major reason is the fact that stocks of farm commodities are at record levels. Look at the figures on these burdensome surpluses: grain sorghum stocks up 15 percent from last year, up 71 percent from 2 years ago; wheat stocks up 16 percent, another record high; and corn stocks up 21 percent, a record high for four of the past 5 years.

It is obvious that we must make drastic reductions in these stocks if farm prices are to increase. Farmers cannot live on credit. To survive, farmers must be able to sell their live products for a profit in the marketplace.

Farmers are not doing that now. Dr. Carl G. Anderson, an economist with the Texas Agricultural Extension Service, has estimated that farmers who had no debt at all had a return on equity last year of minus four to minus seven percent. Even farmers who did not have to pay interest expenses still lost money.

To try to deal with this program, USDA has proposed a Payment In Kind program under which farmers would be paid in commodities rather than in cash for reducing production. Farmers would then take that commodity and sell or use it just as if they had grown it themselves.

However, this is not permitted under our current tax laws. Instead, current law would require farmers to recognize this PIK compensation as income when it was received, not when it was sold. This would have a very damaging effect on many farmers.

Most farmers are cash basis taxpayers. In many cases their products are not sold, and thus are not taxed, until the year after they are produced. In such cases the PIK program would greatly increase the farmer's tax liability by lumping two years of income into one tax year. This is a serious disincentive to participation in the PIK program. It is one we can ill-afford, since good participation in the PIK program is essential if we are to make any substantial progress toward reducing our burdensome surpluses and improving farm prices.

This legislation would correct that situation by providing that PIK commodities would be treated for tax purposes exactly as if they had been grown by the farmer. This would allow cash-basis farmers to recognize and pay taxes on this income when they actually got the cash. In addition, it would avoid potential tax problems for agricultural cooperatives. The bill also addresses another concern by providing that participation in the PIK program will not affect the use of the special use valuation option for agricultural land under the estate tax laws.

It is obvious that our tax code was not drafted with the PIK program in mind. This legislation will make the corrections that are necessary to let the PIK program function as intended, and it should be passed without controversy. However, I must point out that farmers are making their decisions on whether or not to participate in the PIK program right now. The deadline for signing up for the PIK program is March 11, and this legislation needs to be passed before that time so that farmers can be sure that they will not suffer substantial tax penalties if they choose to participate in the PIK program.

For this reason I urge the prompt enactment of this bill into law.

PREPARED STATEMENT OF SENATOR DAVID BOREN

Mr. BOREN. Mr. Chairman, I was pleased to add my name as a cosponsor to the "Payment-in-Kind Clarification Act of 1983" introduced by Senators Grassley and Wallop. I joined them because I feel that the economic condition of American agriculture has reached a serious level, and I'm worried that farmers will be discouraged from signing up for the payment-in-kind program unless we move rapidly to correct its current tax problems.

The "Payment-in-Kind Clarification Act" is designed to address the three principal tax problems associated with the current PIK program. These problems include when a farmer must recognize income from a PIK crop, estate taxation of farm property, and the tax treatment of farmer cooperatives.

For tax purposes, farmers are allowed to defer payment of income taxes on grain they produce until they actually sell it. However farmers may be forced to pay income taxes on PIK crops in the year they are received and not in the year they are sold. This legislation assures the farmer he will be taxed as if he had grown the crop.

Farmers are also currently given special property valuations for estate tax purposes for land currently in use. One of the qualifications which must be met before property must be used as a farm for five of the last eight years prior to the descendant's death. It has been suggested that if a producer who was participating in the PIK program, and thereby had 10 to 30 percent of their land not in production, died during that time, that the PIK land would not qualify for the current use valuation.

The final problem which is addressed in the legislation deals with certain technical aspects of the tax treatment of farmer cooperatives. These provisions were included to assure that participants in the PIK program will not produce adverse consequences with respect to the preservation of the cooperative's current tax status.

Currently other tax problems have come to the surface over such issues as farmers' soil and water expenditures, expenditures for fertilizer and land clearing, and the issue of self employment income and the PIK program. It is my hope that through a hearing such as the one being held today we can work to resolve these issues and put forward a workable solution. The passage of a measure of this type will go a long way toward alleviating the fears of those farmers who are rightfully concerned about the current problems with the PIK program.

OPENING STATEMENT OF SENATOR DAVID PRYOR

Mr. Chairman, I commend you for calling this hearing to examine the tax issues involved in the Payment-in Kind (PIK) program. The tax aspects of the program are extremely important to the farmers of this country, and I hope we can promptly consider legislation to correct the current interpretation by the Internal Revenue Service.

I was surprised to learn that the service had ruled that PIK commodities would be taxable upon receipt at fair market value. Not only will this interpretation create a severe liquidity problem if not reversed, but it is contrary to the way farmers are taxed when they grow crops. Currently they are taxed when the crop is sold, and the service's interpretation is the same as taxing them at harvest and not at the time of sale.

Mr. Chairman, I understand this issue has already been dealt with by a subcommittee of the Ways and Means Committee. I hope we can correct this promptly so that farmers will sign up for the PIK program.

It would indeed be a shame if many farmers failed to participate in the program for fear of tax consequences. If the PIK program is going to work, and farm income improve anytime in the future, there must be a high level of participation in the program. Clarifying the tax issues will certainly encourage maximum participation.

Senator WALLOP. Senator Jepsen, would you please?

STATEMENT OF HON. ROGER W. JEPSEN, A U.S. SENATOR FROM THE STATE OF IOWA

Senator JEPSEN. Thank you, Mr. Chairman.

We meet today under emergency conditions at a time of financial crisis in agriculture, as has been pointed out here. It is not an overstatement to say that it is absolutely critical that we expedite these proceedings. We need to quickly attain our common bipartisan objective of passing legislation which will assure U.S. farmers that they will not be penalized because of their participation in the payment-in-kind program.

Those of us who have sponsored proposed legislation have done so with the best of intentions. It is now time to combine our energies and influence and our legislative proposals and send a clear signal to the U.S. farmers and their financial advisers that their expressed concerns have been heard, understood and remedied by legislation.

To a significant extent, the success of the PIK program in reducing price-depressing surplus grain and cotton stocks and turning the depressed economic condition of agriculture around hinges on this panel's action today. Thousands of farmers are watching and waiting. We must not disappoint them.

In conclusion, I would be remiss if I were not to commend the Chairman and Senator Dole and my Iowa colleague, Chuck Grassley, for the leadership they have taken in this area. Without their interest there would be no hearings; without their involvement, there would be no legislation; without all of us working together, there would be no signal to our farmers that the Congress is willing to act to neutralize the potential negative tax impact of PIK. Farmers owe you a debt of gratitude.

Mr. Chairman, I thank you for this opportunity.

Senator WALLOP. Thank you, Roger.

I would just point out for the record that the earliest biil introduced was yours, and that is a clear demonstration of your concern in this area, too, as a part of all of the things we are up to today. I don't think anyone has a quarrel with that, that we should get there, and not really very much of a quarrel with how we should get there, except that all of the steps along the line should be made clear and taken care of.

Senator JEPSEN. It is my opinion, Mr. Chairman, that the sign-up will be very negatively affected if this legislation does not pass the Congress, and assurance has not been made by the President if he has not signed it that he will sign it. This tax problem will harm the PIK program and may defeat our efforts to improve the depressed farm economy.

It is that serious, and I hope on a bipartisan basis—and I am emphasizing bipartisan, as has been emphasized, on a bipartisan basis here today we continue that trend.

Senator DOLE. This is a bipartisan committee.

Senator JEPSEN. I can tell that. [Laughter.]

Senator WALLOP. Does anyone have any questions for Senator Jepsen?

[No response.]

Senator JEPSEN. Thank you.

Senator WALLOP. Thank you very much.

Next is the Honorable John Chapoton, Assistant Secretary for Tax Policy, Department of Treasury. Welcome Buck.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you, Mr. Chairman.

I appreciate the opportunity to appear before the committee and subcommittees today to present the Treasury Department's views on the various bills dealing with the PIK program. We have a longer statement that we would request be inserted in the record. I will try to be relatively brief.

Senator WALLOP. By all means.

Mr. CHAPOTON. The PIK program, as you, of course, know, is a land diversion program designed to reduce the amount of certain agricultural commodities in the marketplace, thereby raising prices

of the commodities. Under the program, the Department of Agriculture will compensate a participating farmer for removing acreage from active production by giving the farmer a percentage of the amount of the commodity he otherwise could have grown.

The commodity will be made available to the farmer at the time of normal harvest, but the Government will pay storage costs for up to an additional 5 months.

The income tax consequences are, of course, of significance to us. Today under current law a farmer would realize gross income from the transaction equal to the fair market value of the commodity he receives or is entitled to receive at the time the commodity is made available to him.

He would take a tax basis in the commodity equal to that fair market value equal to the amount he includes in taxable income, and he would recognize additional gain or loss when he sold the commodity at a later point, depending upon whether the sales price was more or less than the fair market value on the earlier inclusion when he received the commodity.

If the commodity were used for feed, the farmer would be entitled to deduct his basis in it when it is so used. In the case of a farmer who has a nonrecourse loan outstanding from the CCC secured by commodities stored either on their own premises or in warehouses, the situation is more complicated.

The PIK program would be implemented for these farmers in two steps. First, the CCC will purchase the commodity from the farmer for an amount equal to the outstanding loan secured by the commodity, and the loan will thereby be discharged; and second, the CCC will then deliver that exact commodity or the warehouse receipt representing that commodity to the farmer as his payment-in-kind under the PIK program.

The income tax consequences to that farmer would depend upon whether he had made an election under section 77 of the code to treat the nonrecourse loan from the CCC as a sale for tax purposes when that loan was originally made. If he made a section 77 election, the loan proceeds are included in his income in the year of the receipt of the loan proceeds, and the cancellation of the loan as a first step in the PIK program would have no further tax circumstances, and the transfer of the commodity to the farmer would have tax consequences under existing law, the same tax consequences I described above, that is, fair market value would be included in income on the date of receipt.

In the case of a farmer who has not made a section 77 election and is involved in a CCC loan, then since the loan was treated as a loan and not a sale when it was originally made, the PIK transaction as to that farmer would have two effects. First, he would realize taxable income when the loan was forgiven as though he had sold the commodity to the CCC. That would be one step of taxable income.

Then he would have taxable income a second time equal to the fair market value of the commodity he receives in the PIK transaction. As has been mentioned by the Chairman, there are estate tax consequences involved in the PIK program, basically the special use provisions of section 2032A, which provide a lower valuation method for property used in farming.

The question is whether those provisions would be applicable to property that is committed to the PIK program. The two requirements that give concern under existing law are, first, that the property must have been owned by the decedent or a member of his family and used "as a farm for farming purposes" in 5 out of the last 8 years preceding his death; and second, the requirement that there must have been material participation in the operation of the farm by the decedent or a member of his family during that 5-year period.

Also, section 2032A requires recapture of the estate tax benefit resulting from special use valuation if the qualified heir who receives the property disposes of it or ceases to use the property as a farm for farming purposes within 10 years after the decedent's death.

So you could have the same type question arising after the death, that is, whether the property which is committed to the PIK program meets the test that it must be used as a farm for farming purposes. None of these estate tax questions is specifically addressed in current law or regulations.

We have since this matter came up, we and the Internal Revenue Service, have looked at the present law quite thoroughly, and as Chairman Dole mentioned earlier, the Internal Revenue Service has determined that participation in the PIK program will generally not prevent satisfaction of the requirements in section 2032A that I just discussed or section 6166, which allows a deferral of estate taxes in certain cases if there is the estate tax attributable to the active conduct of a trade or business.

So while I raised questions in my testimony before the House Ways and Means Subcommittee, certain questions where the entire farm might be committed to the PIK program, the Internal Revenue Service has determined there is no problem, and a formal announcement will be issued on that point sometime this week, probably tomorrow.

In my written testimony, Mr. Chairman, I go through some of the specifics of the three bills before you, but I think I will not do that today. Let me just discuss a couple of the points that we want to make. First, some need for tax relief is present because many farmers who participate in the PIK program will have sold crops in the current year which they have harvested in a prior year, and under current law they will, therefore, have in effect in the current year income from two crops.

In addition, farmers participating in the PIK program will be under pressure to sell commodities to obtain cash to pay their tax liability if current law is applicable to them, and those sales, those forced sales could have the effect of flooding the market and, indeed, increase the problem the PIK program is designed to reduce.

In addition, these potential tax and market problems could discourage participation in the PIK program and thus frustrate the Federal agricultural policy in this regard. For these reasons, the Treasury Department strongly supports the changes in the current law which adopt the general policy underlying each of the three bills before you because the PIK payments in effect are replace-

ments for commodities the farmer would otherwise have been expected to grow.

The tax law should treat farmers who receive commodities under the program as if they had grown the commodities themselves. Thus, the farmer should recognize income only in the year they actually sell or otherwise dispose of the commodity in question.

We have a number of technical comments on each of the bills before you. We go into some detail. I think I will not repeat those now, but I think they are important because some of them deal with which section of the code the relief should be provided under, some deal with the basis to the farmer, and we should be very careful because we are writing a special rule for a special situation in this case.

Finally, with respect to the estate tax consequences, we would not have any concern if the committee adopted legislation making it clear that farmers who participate in the PIK program will not adversely affect their eligibility for special use under section 2032A or their eligibility for deferral under section 6166.

The subcommittee in the House has done that, and even though there will be a release dealing with this this week, a special provision in this bill would not be a matter of concern if the subcommittee felt it wanted to provide absolute certainty in this area.

Mr. Chairman, that pretty well summarizes our position on the bill before you, and I would be happy to answer any questions you might have.

[The statement of Mr. Chapoton follows:]

For Release Upon Delivery
Expected at 2 p.m. EST
February 28, 1983

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY
(TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
AND THE
SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE
OF THE
SENATE FINANCE COMMITTEE

Messrs. Chairmen and Members of the Subcommittees:

I am pleased to have the opportunity to present the views of the Treasury Department on S. 446, S. 495, and S. 527. All three of these bills deal with the tax treatment of farmers who participate in the Administration's Payment-in-Kind (PIK) program. Although we have some technical comments on the bills as currently drafted, the Treasury Department strongly supports legislation which would remove any disincentives in current tax law to farmers' participation in the PIK program.

BACKGROUND

The PIK program is a land diversion program designed to reduce the amount of certain agricultural commodities in the marketplace, thereby raising the prices of such commodities. Under the PIK program, the Department of Agriculture will compensate a participating farmer for removing acreage from active production by giving the farmer a percentage of the

amount of the commodity he otherwise could have grown. The commodity is to be available to the farmer at the time of normal harvest, although the government will pay storage costs for up to five additional months.

Income Tax Consequences

Under current income tax law, a farmer would realize gross income from this transaction equal to the amount of the fair market value of the commodity received at the time the commodity is made available to him. The farmer would take a tax basis in the commodity equal to the amount included in income. He would recognize additional income (or loss) from the sale of the commodity if the amount realized from such sale exceeds (or is less than) the amount already included in income. Further, the farmer would be entitled to deduct his basis in the commodity to the extent it is used for feed.

The current law income tax treatment of the transaction involved in the PIK program is more complicated in the case of farmers who have nonrecourse loans outstanding from the Commodity Credit Corporation (CCC) secured by commodities which they either store on their own premises or in warehouses. The Department of Agriculture proposes to implement the PIK program for these farmers in two steps, as follows:

(1) the CCC will purchase the commodity from the farmer for an amount equal to the outstanding loan which is secured by the commodity, and the loan will thereby be discharged; and

(2) the CCC will then deliver that exact commodity or, in the case of farmers whose commodities are stored in warehouses, the warehouse receipt representing the commodity, to the farmer as his payment-in-kind under the PIK program.

The income tax consequences to a farmer in these circumstances would depend upon whether the farmer has made an election under section 77 of the Internal Revenue Code to treat the nonrecourse loan from the CCC as a sale for tax purposes. If the farmer makes a section 77 election, the loan proceeds are included in the farmer's income in the year of receipt. Since a farmer who has made a section 77 election has already been taxed on the proceeds of his CCC loan, the cancellation of that loan in exchange for the commodity securing the loan would have no further tax consequences to the farmer. The subsequent transfer of the commodity back to the farmer would be subject to the same tax treatment as described above; that is, the farmer would have

gross income equal to the fair market value of the commodity when it is made available to him and would take a basis in the commodity equal to that value.

In the case of farmers who do not make a section 77 election, the CCC loan, when made, is treated as a loan rather than a sale. Therefore, the PIK transaction would be treated as a sale of the commodity for an amount equal to the outstanding debt which the commodity secured, followed by receipt of the commodity as a PIK payment. The result would be that the farmer would be taxed first on the amount of the debt which was discharged in the sale transaction and second on the amount of the fair market value of the commodity received in the PIK transaction. However, as discussed above, the farmer would take a basis in the commodity received equal to its value.

Estate Tax Consequences

Under section 2032A of the Internal Revenue Code, if certain requirements are met, real property which is used as a family farm and which passes to or is acquired by a qualified heir may be included in a decedent's estate at its current use value, rather than its full fair market value. Among the requirements which must be satisfied are: (1) the property must have been owned by the decedent or a member of his family and used "as a farm for farming purposes" on the date of the decedent's death and for periods aggregating five years or more during the eight-year period ending with the decedent's death; and (2) there must have been "material participation" in the operation of the farm by the decedent or a member of his family for periods aggregating five years or more out of the eight-year period ending on the date of the decedent's death.

Section 2032A also provides that the estate tax benefit of special use valuation generally is recaptured if the qualified heir disposes of the property to a nonfamily member or ceases to use the property "as a farm for farming purposes" within 10 years after the decedent's death and before the qualified heir's death. With certain exceptions, the qualified heir ceases to use the property for the qualified farming use if he or members of his family fail to participate materially in the farm operation for periods aggregating more than three years during any eight-year period ending after the decedent's death and before the qualified heir's death.

Another estate tax provision relevant to many farmers participating in the PIK program is section 6166 of the Code, which allows deferred payment of estate tax attributable to qualifying closely held business interests owned by decedents. The benefits of section 6166 are limited to interests in active trades or businesses.

A question may arise whether property on which a cash crop is not being grown as a result of participation in the PIK program, or in some other acreage-reduction program sponsored by the Department of Agriculture, is nevertheless being used "as a farm for farming purposes" within the meaning of section 2032A. Similar questions may be posed as to whether there has been the requisite "material participation" for purposes of section 2032A and whether the property is part of an active trade or business qualifying for estate tax deferral under section 6166.

Although none of these estate tax questions is specifically addressed in the present statute or regulations, we believe that the dedication of land to an acreage-reduction program sponsored by the Department of Agriculture generally will not prevent satisfaction of the requirements of section 2032A or section 6166 under present law. As I indicated in my testimony delivered before the Select Revenue Measures Subcommittee of the House Ways and Means Committee last Wednesday, February 23, we initially had some question about the result in cases where a farmer removes his entire farm from active production under an acreage-reduction program sponsored by the Department of Agriculture. Based on our further study of the issues involved, however, we are now of the view that land dedicated to such a program should be considered as used for farming purposes and that material participation in such a program should be viewed as material participation in an active farming business for all relevant tax purposes. I anticipate that the Internal Revenue Service will issue a formal announcement this week to confirm this treatment under current law.

DESCRIPTION OF S. 495

S. 495 is identical in all relevant respects to H.R. 1296, a bill on which I testified on Wednesday, February 23, before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee. At that hearing I expressed Treasury's strong support for legislation adopting the general policy position of H.R. 1296 and S. 495, although I noted a number of technical comments on the bill. A copy of my written statement before the Select Revenue Measures Subcommittee is attached to this statement. In light of my

previous testimony, I will confine the balance of my remarks today to the other two bills, S. 446 and S. 527.

DESCRIPTION OF S. 446 AND S. 527

Income Tax Provisions

S. 446 would amend section 451 of the Code, which relates to the taxable year income is to be taken into account for tax purposes, by providing that no income would be realized upon the receipt or right to receive any commodity under a certified payment-in-kind program (which would include the current PIK program), but that income would be realized from a subsequent sale or exchange of such commodity. For purposes of determining the amount realized from such sale or exchange, the farmer would have a zero tax basis in the commodity and the character of the income from the sale or exchange would be ordinary. S. 527 contains similar provisions. In addition, S. 527 provides that the cost basis of a taxpayer's payment in kind will be zero for all purposes of the Code, and that the character of the gain realized from the sale or exchange of the payment in kind (or any property the basis of which is determined by reference to the basis of the payment in kind) will be taxed in the same manner as a crop grown by the taxpayer.

S. 527 also provides that where farmers have outstanding CCC loans, the tax treatment of the receipt of the payment in kind will be determined without regard to any related transaction involving the loan. Where a taxpayer has made an election under section 77 with respect to a loan, the loan aspect of the PIK transaction will be treated as the closing of the sale deemed made pursuant to the section 77 election. Where no section 77 election has been made, the taxpayer would be deemed to have sold the commodity securing the loan in exchange for a cancellation of the loan.

In addition, S. 527 addresses a number of ancillary income tax issues raised by the PIK program. The bill provides that for purposes of the Internal Revenue Code and the Social Security Act, any income received from the sale or exchange of a taxpayer's payment in kind will be treated as income from the trade or business of farming and that a taxpayer will be treated as engaged in the trade or business of farming with respect to any land diverted pursuant to the PIK program. With respect to a cash basis taxpayer, S. 527 provides that any amount a taxpayer is entitled to receive as reimbursement for storage will not be included in income until actually received by the taxpayer.

S. 527 also contains special rules for cooperatives which provide that any cooperative which markets a commodity received by, or on behalf of, a member or patron under a certified payment-in-kind program will be treated as marketing the product of such member or patron.

Estate Tax Provisions

S. 446 also would amend section 2032A of the Code to provide that any commodity received by a person under a certified payment-in-kind program shall be treated as having been produced by such person on the property dedicated to such program. The bill does not refer specifically to either the qualified use test or the material participation test.

S. 527 would add two new paragraphs to section 2032A to provide that property diverted from farm use for up to three years under a certified payment-in-kind program shall be treated as used for a qualified use. This bill has no corresponding provision, however, relating to the material participation test.

S. 446 has no provision which addresses the effect of the PIK program on section 6166. S. 527, on the other hand, provides that property used in the trade or business of farming shall not be treated as withdrawn from such trade or business if such property is diverted from use for farming purposes solely by reason of participation in a certified payment-in-kind program. This provision would not apply, however, in determining whether the estate of a farmer who died with all or a portion of his property withdrawn from active farm production pursuant to a certified payment-in-kind program would remain eligible for estate tax deferral under section 6166.

DISCUSSION

Timing of Income Recognition

Many farmers participating in the PIK program will have sold crops in the current taxable year which were harvested in a prior taxable year. Current law may impose a hardship on these taxpayers because they will have, in effect, income from two crops (the income from the prior year's crop that is sold, plus the income from the PIK payment) in the same taxable year. In addition, under current law, farmers participating in the PIK program will be under pressure to sell commodities to obtain cash to pay their income tax liabilities arising from the actual or constructive receipt of the PIK payments; and those sales may have to be made in a

market flooded with commodities being sold by other farmers facing the same tax liquidity problem. These tax-motivated sales may cause farm commodity market problems of the type that the PIK program is designed to reduce. The potential tax and market problems also may discourage farmers from participating in the PIK program, thus frustrating Federal agricultural policy.

In view of these problems, the Treasury Department strongly supports changes in the current law which adopt the general policy position underlying S. 446 and S. 527. Because PIK payments, in effect, are replacements for the commodities which farmers could have been expected to produce from the normal use of land devoted to the program, the tax law should treat farmers who receive commodities under the program as if they had grown the commodities themselves. Under this approach, farmers would recognize income only in the year they actually sell or otherwise dispose of the commodities in question. However, as I indicated earlier, we do have some technical comments on the bills as currently drafted.

First, we do not believe that the legislation should be drafted as an amendment to section 451 of the Code. Section 451 relates to the timing of the recognition of income depending upon the taxpayer's method of accounting. Under either the cash or accrual method of accounting, a PIK payment would be recognized for tax purposes in the year the farmer receives or has a right to receive the payment. The issue is not one of timing but one of income inclusion. We believe that the bill should be drafted to provide an exclusion from gross income for commodities received under the PIK program and, further, to provide that those commodities will have a zero basis for income tax purposes.

Second, we believe any bill enacted by Congress in this area should make it clear that a taxpayer will have a zero cost basis in any commodity received under the PIK program for all purposes of the Code and not just on the sale or exchange of the commodity. While S. 527 accomplishes this result, S. 446 does not.

Third, the questions whether PIK payments should be treated as if farmers had grown the commodities themselves and whether farmers who divert some or all of their acreage under the PIK program should be considered as engaged in the trade or business of farming are questions that have ramifications for a number of other provisions of the Code. For instance, section 447 provides special accounting rules for corporations engaged in the trade or business of farming.

Section 175 provides special treatment for soil and water conservation expenditures for taxpayers engaged in farming. Tax exempt farmers' cooperatives could lose their exemptions if the commodities received by their members and assigned to the cooperatives were not treated as produced by the members. Moreover, a determination of the self-employment income of a farmer who diverts acreage pursuant to the PIK program also depends on whether the farmer is deemed to participate materially in the production of farming commodities or the management of that production.

We believe that farmers who receive PIK payments should be treated as if they had grown the commodities received for all purposes of the Code and that participation in a Department of Agriculture program should be treated as a farming activity. We believe this result can be reached in most cases under current law. However, the legislation should address these ancillary issues to the extent that current law needs to be clarified to ensure appropriate results. S. 527 addresses these ancillary issues, but S. 446 does not.

Estate Tax Consequences

Treasury generally supports legislation which would make it clear to farmers that participation in the PIK program will not adversely affect their eligibility for special use valuation under section 2032A or estate tax deferral under section 6166. We believe that any such legislation should apply to the pre-death qualification requirements of these two sections as well as the post-death recapture provisions of section 2032A(c) and acceleration provisions of section 6166(g).

Neither S. 446 nor S. 527 addresses all these concerns. With respect to section 2032A, S. 446 simply provides that a person who receives a crop pursuant to a certified payment-in-kind program will be treated as if he had grown the crop. While the language of the bill reflects the general approach which we believe is correct, some additional and more specific language relating to the qualified use and material participation tests may be desirable. S. 527 has the desired specificity for the qualified use test, but does not deal with the material participation test.

As noted above, S. 446 has no provision dealing with section 6166 whatsoever. S. 527 adequately addresses the post-death concerns by providing, in effect, that participation in the PIK program cannot cause an acceleration of estate tax deferred under section 6166. S. 527 fails, however, to cover the equally important pre-death qualification test of this section. If legislation is desired to clarify the results under section 6166, the bill should contain a comprehensive provision addressing all relevant concerns.

CONCLUSION

In conclusion, I would like to reiterate Treasury's strong support of legislation that will remove any impediment to the successful operation of the PIK program which current tax law may create. While I have noted some technical comments on the bills as currently drafted, I am confident that we can work out a satisfactory solution to these problems with the Subcommittees.

I would be happy to answer your questions.

For Release Upon Delivery
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STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY
(TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE
HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on H.R. 1296, which deals with the tax treatment of farmers who participate in the Administration's Payment-in-Kind (PIK) program. Although we have some technical comments on the bill as currently drafted, the Treasury Department strongly supports legislation which would remove any disincentives in current tax law to farmers' participation in the PIK program.

BACKGROUND

The PIK program is a land diversion program designed to reduce the amount of certain agricultural commodities in the marketplace, thereby raising the prices of such commodities. Under the PIK program, the Department of Agriculture will compensate a participating farmer for removing acreage from active production by giving the farmer a percentage of the amount of the commodity he otherwise could have grown. The commodity is to be available to the farmer at the time of normal harvest, although the government will pay storage costs for up to five additional months.

Income Tax Consequences

Under current income tax law, a farmer would realize gross income from this transaction equal to the amount of the

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fair market value of the commodity received at the time the commodity is made available to him. The farmer would take a tax basis in the commodity equal to the amount included in income. He would recognize additional income (or loss) from the sale of the commodity if the amount realized from such sale exceeds (or is less than) the amount already included in income. Further, the farmer would be entitled to deduct his basis in the commodity to the extent it is used for feed.

The current law income tax treatment of the transaction involved in the PIK program is more complicated in the case of farmers who have nonrecourse loans outstanding from the Commodity Credit Corporation (CCC) secured by commodities which they either store on their own premises or in warehouses. The Department of Agriculture proposes to implement the PIK program for these farmers in two steps, as follows:

(1) the CCC will purchase the commodity from the farmer for an amount equal to the outstanding loan which is secured by the commodity, and the loan will thereby be discharged; and

(2) the CCC will then deliver that exact commodity or, in the case of farmers whose commodities are stored in warehouses, the warehouse receipt representing the commodity, to the farmer as his payment-in-kind under the PIK program.

The income tax consequences to a farmer in these circumstances would depend upon whether the farmer has made an election under section 77 of the Internal Revenue Code to treat the nonrecourse loan from the CCC as a sale for tax purposes. If the farmer makes a section 77 election, the loan proceeds are included in the farmer's income in the year of receipt. Since a farmer who has made a section 77 election has already been taxed on the proceeds of his CCC loan, the cancellation of that loan in exchange for the commodity securing the loan would have no further tax consequences to the farmer. The subsequent transfer of the commodity back to the farmer would be subject to the same tax treatment as described above; that is, the farmer would have gross income equal to the fair market value of the commodity when it is made available to him and would take a basis in the commodity equal to that value.

In the case of farmers who do not make a section 77 election, the CCC loan, when made, is treated as a loan rather than a sale. Therefore, the PIK transaction would be treated as a sale of the commodity for an amount equal to the outstanding debt which the commodity secured, followed by

receipt of the commodity as a PIK payment. The result would be that the farmer would be taxed first on the amount of the debt which was discharged in the sale transaction and second on the amount of the fair market value of the commodity received in the PIK transaction. However, as discussed above, the farmer would take a basis in the commodity received equal to its value.

Estate Tax Consequences

Under section 2032A of the Internal Revenue Code, if certain requirements are met, real property which is used as a family farm and which passes to or is acquired by a qualified heir may be included in a decedent's estate at its current use value, rather than its full fair market value. Among the requirements which must be satisfied are: (1) the property must have been owned by the decedent or a member of his family and used "as a farm for farming purposes" on the date of the decedent's death and for periods aggregating five years or more during the eight-year period ending with the decedent's death; and (2) there must have been "material participation" in the operation of the farm by the decedent or a member of his family for periods aggregating five years or more out of the eight-year period ending on the date of the decedent's death.

Section 2032A also provides that the estate tax benefit of special use valuation generally is recaptured if the qualified heir disposes of the property to a nonfamily member or ceases to use the property "as a farm for farming purposes" within 10 years after the decedent's death and before the qualified heir's death. With certain exceptions, the qualified heir ceases to use the property for the qualified farming use if he or members of his family fail to participate materially in the farm operation for periods aggregating more than three years during any eight-year period ending after the decedent's death and before the qualified heir's death.

Another estate tax provision relevant to many farmers participating in the PIK program is section 6166 of the Code, which allows deferred payment of estate tax attributable to qualifying closely held business interests owned by decedents. The benefits of section 6166 are limited to interests in active trades or businesses.

A question may arise whether property on which a cash crop is not being grown as a result of participation in the PIK program, or in some other acreage-reduction program sponsored by the Department of Agriculture, is nevertheless

being used "as a farm for farming purposes" within the meaning of section 2032A. Similar questions may be posed as to whether there has been the requisite "material participation" for purposes of section 2032A and whether the property is part of an active trade or business qualifying for estate tax deferral under section 6166.

None of these estate tax questions is specifically addressed in the present statute, and neither the regulations nor the published rulings have addressed these exact issues. It is Treasury's view, however, that the dedication of land to an acreage-reduction program sponsored by the Department of Agriculture generally should not prevent satisfaction of the requirements of section 2032A or section 6166 under present law, particularly where a portion of the farm remains in active production. In such a case, there would still be property used as a farm for farming purposes and material participation in its operation. Moreover, nothing in section 2032A or section 6166 requires that its tests be applied on an acre-by-acre basis. The fact that a portion of a farm is temporarily left fallow or covered with a conservation crop pursuant to an agreement with the Department of Agriculture does not mean that such portion is no longer a part of the farm or that it is not being used for farming purposes. In fact, fields are often temporarily removed from active production for soil conservation or other farming reasons having nothing to do with Federal acreage-reduction programs.

If a farmer removes his whole farm from active production, however, the result is somewhat less clear. In particular, if no portion of the farm is being used for farming purposes in the traditional sense, it is unclear whether there can be the required material participation in a farming operation. Also, it may be argued that if an entire farm is withdrawn from production, it has ceased to be used as a farm during that period.

DESCRIPTION OF H.R. 1296

Income Tax Provisions

H.R. 1296 would amend section 451 of the Code, which relates to the taxable year income is to be taken into account for tax purposes, by providing that a taxpayer may elect to exclude the value of commodities received under the PIK program from income in the year of receipt and to treat the commodities as if they were grown by him. Any commodities with respect to which such an election is made would have a zero basis for tax purposes. Thus, the farmer would realize income only at the time he sells the

commodities or, if he uses the commodities for livestock feed, at the time he sells the livestock to which the commodities were fed.

Further, the bill would provide that taxpayers who would otherwise have to recognize income by reason of the cancellation of a CCC loan may elect to defer such income recognition. Under this election, a portion of the total proceeds from the cancelled loan would be included in income in the year the loan is cancelled and in succeeding taxable years in an amount equal to the proportion of the total commodity which secured the loan that is sold or consumed in each such taxable year.

Taxpayers may make either or both of the elections provided by H.R. 1296 separately with respect to each PIK payment received and each loan cancelled under the program.

Estate Tax Provisions

H.R. 1296 also would amend section 2032A to provide that the fact that property is removed from production pursuant to a "qualified Federal farmland removal program," shall not prevent (i) such property from being treated as used as a farm for farming purposes nor (ii) any individual from materially participating in the operation of the farm with respect to any property. A "qualified Federal farmland removal program" is any Federal program for removing land from agricultural production, including (but not limited to) the PIK program.

H.R. 1296 does not contain any provision which specifically addresses the effect of the PIK program on section 6166.

DISCUSSION

Timing of Income Recognition

Many farmers participating in the PIK program will have sold crops in the current taxable year which were harvested in a prior taxable year. Current law may impose a hardship on these taxpayers because they will have, in effect, income from two crops (the income from the prior year's crop that is sold, plus the income from the PIK payment) in the same taxable year. In addition, farmers participating in the PIK program will be under pressure to sell commodities to obtain cash to pay their income tax liabilities arising from the actual or constructive receipt of the PIK payments; and those sales may have to be made in a market flooded with

commodities being sold by other farmers facing the same tax liquidity problem. These tax-motivated sales may cause farm commodity market problems of the type that the PIK program is designed to reduce. The potential tax and market problems also may discourage farmers from participating in the PIK program, thus frustrating Federal agricultural policy.

In view of these problems, the Treasury Department strongly supports changes in the current law which adopt the general policy position underlying H.R. 1296. Because PIK payments, in effect, are replacements for the commodities which farmers could have been expected to produce from the normal use of land devoted to the program, the tax law should treat farmers who receive commodities under the program as if they had grown the commodities themselves. Under this approach, farmers would recognize income only in the year they actually sell or otherwise dispose of the commodities in question. However, as I indicated earlier, we do have some technical comments on the bill as currently drafted.

First, we do not believe that the bill should be drafted as an amendment to section 451 of the Code. Section 451 relates to the timing of the recognition of income depending upon the taxpayer's method of accounting. Under either the cash or accrual method of accounting, a PIK payment would be recognized for tax purposes in the year the farmer receives or has a right to receive the payment. The issue is not one of timing but one of income inclusion. We believe that the bill should be drafted to provide an exclusion from gross income for commodities received under the PIK program and, further, to provide that those commodities will have a zero basis for income tax purposes.

Second, the bill would permit farmers who have not made a section 77 election to take any amounts realized from the CCC loans into income as the commodities are sold or consumed, rather than at the time the loans are discharged. We seriously question whether such relief is warranted. In such cases, the farmers already have received the cash necessary to pay any tax resulting from the income realized from the loan proceeds. Further, this provision of the bill would provide farmers who have not made a section 77 election with a significant advantage over those farmers who have made an election and have already paid tax on the loan proceeds received.

Third, we believe that the income tax rules provided by the bill should be mandatory rather than elective. Mandatory rules would be fully consistent with the objective of treating farmers who participate in and receive commodities under the PIK program as if they had grown the commodities themselves. We acknowledge that some taxpayers may have made the decision to enter into contracts with the Department of Agriculture based on the tax consequences under current law. If such taxpayers want taxable income during the current taxable year, however, they generally can achieve that result by selling the commodities received pursuant to the program in the current taxable year.

Special Use Valuation

Treasury generally supports the provisions of H.R. 1296 relating to section 2032A of the Code. To the extent that present law is unclear, these provisions will assure farmers that participation in the PIK program will not adversely affect their eligibility for special use valuation. Moreover, the provisions in H.R. 1296 dealing with section 2032A are consistent with the general approach of treating farmers as if they had grown the PIK commodities on the land they dedicate to the program.

Other Tax Consequences

The questions whether PIK payments should be treated as if farmers had grown the commodities themselves and whether farmers who divert some or all of their acreage under the PIK program should be considered as engaged in the trade or business of farming are questions that have ramifications for a number of other provisions of the Code. For instance, section 447 provides special accounting rules for corporations engaged in the trade or business of farming. Section 175 provides special treatment for soil and water conservation expenditures for taxpayers engaged in farming. Tax exempt farmers' cooperatives could lose their exemptions if the commodities received by their members and assigned to the cooperatives were not treated as produced by the members. Moreover, a determination of the self-employment income of a farmer who diverts acreage pursuant to the PIK program also depends on whether the farmer is deemed to participate materially in the production of farming commodities or the management of that production. Finally, a decedent's eligibility for estate tax deferral under section 6166 could be threatened if property involved in the PIK program is not treated as being used in an active trade or business. H.R. 1296 does not deal with any of these ancillary issues.

We believe that farmers who receive PIK payments should be treated as if they had grown the commodities received for all purposes of the Code and that participation in a Department of Agriculture program should be treated as a farming activity. We believe this result can be reached in most cases under current law. However, the legislation should address these ancillary issues to the extent that current law needs to be clarified to ensure appropriate results.

CONCLUSION

In conclusion, I would like to reiterate our strong support of legislation that will remove any impediment to the successful operation of the PIK program which current tax law may create. While I have noted some technical comments on the bill as currently drafted, I am confident that we can work out a satisfactory solution to these problems with the Subcommittee.

I would be happy to answer your questions.

Senator WALLOP. Thank you very much.

We will follow the early bird rule here. Senator Dole was the first in today.

Senator DOLE. [Indicating.]

Senator WALLOP. Chuck.

Senator GRASSLEY. In other words, as you reviewed the House bill and our bills, they will do exactly what the ruling is going to do. I want to make sure we are both doing exactly the same thing so that if we decide not to do it because you are issuing the ruling, your ruling is accomplishing what we want to accomplish.

Mr. CHAPOTON. The three bills before the subcommittees today deal with the estate tax problems in different ways. The House bill deals with all of the problems we see and is probably the most comprehensive of the three.

Senator GRASSLEY. So the answer is affirmative, then, at least as to the House bill.

Mr. CHAPOTON. That is correct.

Senator GRASSLEY. It is not in any of the bills before this committee, but I sure need your view on this, that is, a part of the House bill that tries to take care of the tax exempt status for the National Farmers Organization. Do you have a view on that?

Mr. CHAPOTON. Yes, Senator Grassley, we do. We oppose that provision. It is special relief for a special situation that, frankly, we do not think calls for relief. We have a bill report up on that bill. Basically it says that marketing activities by this co-op or a similarly situated co-op—excuse me, not the co-op, but this organization—as finally drafted by the subcommittee in the House, the provision would be limited to this one organization. The bill simply says that the organization marketing activities on behalf of its members will not cause it to lose its tax exemption.

We think that is not appropriate and, indeed, it will cause an unfair competitive situation vis-a-vis some taxable co-ops who complained about a decade ago when this problem first appeared that that organization should not be tax exempt with respect to this activity while they are taxable with respect to the same activity.

Senator GRASSLEY. Is there any problem as far as the Treasury Department is concerned if we were not to have a bill passed and signed by the President by March 11? Would the fact that it is passed later than that affect Treasury's decisions vis-a-vis the farmer's income tax, or would you take a position that the position taken by the two Houses prior to March 11 would be satisfactory?

Mr. CHAPOTON. I think the bill when passed would have an earlier effective date, so I think even if passed later, but for the publicity side of it, it would be no problem.

Senator GRASSLEY. One of the four or five bills floating around here, I don't recall whether on the House side or the Senate side, tried to deal with this problem of advance deficiency payments and the diversion payments for the people who signed up for this year's program before the PIK part of it was announced.

The Treasury is still debating how to handle that as income. Are we going to be able to get a ruling on that pretty soon?

Mr. CHAPOTON. That would depend entirely—are you talking about the estate tax consequences?

Senator GRASSLEY. No, income tax.

Mr. CHAPOTON. That would depend entirely on the effective date in the bill. I was not aware.

Senator GRASSLEY. No, I don't think we are trying to deal with that, but this is still a problem. If we had not had the PIK program, then we would have had the problem of people who had signed up for the 1983 program when it was announced in October, they could do that October, November, and December, and then PIK wasn't announced until January, and they can still sign up for just that portion of it and forget about the PIK part of it.

But the determination of whether or not that is income for 1982 or 1983 normally would be based upon when it was received as income, but there is some indication it might not be considered that way now.

Mr. CHAPOTON. I am familiar with what you are talking about now. The question has arisen on whether there is constructive receipt. We have looked at that. The IRS is looking at that now, whether the restrictions on the availability, the right to receive that income would prevent realization under constructive receipt rules.

It would not be dealt with, you are right, with the bills before you today. I think we should wait. My judgment is that there is not constructive receipt. My present thinking is there is not constructive receipt under the facts of those cases as we know them and therefore the farmers would be OK, but that is the final determination the IRS will have to make.

Senator GRASSLEY. I would urge you to see if they can be speeded up. It would be very helpful.

Mr. CHAPOTON. It is on the front burner.

Senator DOLE. I think you have addressed the question on the estate tax issues that can be handled on an administrative level. You are going to issue a press release tomorrow on that?

Mr. CHAPOTON. This week, hopefully by tomorrow. It is being drafted now. We have looked at drafts already.

Senator DOLE. My question is, Is it better to try to do it administratively than get bogged down with some legislative language that might further complicate or could complicate it?

Mr. CHAPOTON. If the legislative language were adopted, we would certainly like it to say that with respect to the PIK program, it has no inference with respect to similar rules applicable to other land diversion programs. So indeed, the best course might be, if everyone is satisfied with the language of the press release, to let that be the entire rule.

Senator DOLE. If the press release is tomorrow, we have a markup scheduled Wednesday morning on this legislation, and maybe we could address that with Treasury sometime tomorrow.

Mr. CHAPOTON. OK.

Senator DOLE. Someone has suggested that PIK tax legislation should include rules to discourage speculation by nonfarmers with farmland withdrawn from production. Has the Treasury looked at that?

Mr. CHAPOTON. Yes, we have looked at that, Senator Dole. The subcommittee bill does adopt language which is certainly satisfactory to us. It does, in other words, prevent nonfarmers from coming in and using this benefit as an encouragement to speculation. It

seems to us it makes sense and should not undermine the program at all.

Senator DOLE. So it is properly addressed in that bill?

Mr. CHAPOTON. We think it is properly addressed in that bill.

Senator DOLE. And the obvious question, I guess, is I assume Treasury would not like us to load this up with other tax amendments.

Mr. CHAPOTON. I think that is of critical importance, Senator Dole, that we not load this up with other amendments.

Senator DOLE. If someone offered the amendment to repeal withholding of interest on dividends. I assume you would find it hard to accept.

Mr. CHAPOTON. We would simply suggest that this legislation await a clean bill approach. We simply would have a great deal of difficulty with that. Then it would become a major revenue loser when it is intended to be a relief provision.

Senator DOLE. Well, I am not certain anyone has thought of that, but I thought of it. [Laughter.]

And I do not believe the American Bankers Association would do that to the American farmer, although they might if they could get away with it.

But I do not really think the American Bankers Association and their multimillion dollar campaign to help undue the economic package we put together last year in the face of record high interest rates, with most banks showing record profits, would want to kill this bill. But I would not put it past them.

Mr. CHAPOTON. I can say that on both sides, both the House side and this side in the Senate, we have seen such strong support for relief legislation in this area that it should be possible without controversy once we all agree on the format of the legislation. And to throw that very controversial measure in with it, which we would have to very strongly oppose, would be indeed unfortunate.

Senator DOLE. I do not think that would happen, but I just want to be sure that the right signal was sent.

Mr. CHAPOTON. Yes, sir, I think we can send that signal. I hope we have sent that signal, and we would send it very strongly again.

Senator GRASSLEY. The signal was sent a couple of weeks ago.

Senator DOLE. I must say, I do not want to get off on this right now, but a lot of bankers are looking at that legislation again and deciding it is not quite as bad as they thought it was, because it is simply getting people to pay taxes who were not paying taxes.

And we discussed with Senator Grassley and others who have a concern to make certain we are not burdening the banks or burdening the people trying to save money. If that is the case, we ought to take a look at it. But this is not a hearing on withholding on interest and dividends.

Mr. CHAPOTON. If I might say, even though it is not a hearing on that question, we have looked at this again and again. It is clearly not an impediment to savings. There is a legitimate concern about the cost to banks, and I think some of these concerns can be addressed and are being addressed. The float allowed banks to pay for their startup costs ought to be sufficient to take care of that problem.

Senator DOLE. I do not have any other questions on this bill. [Laughter.]

Senator WALLOP. Senator Baucus.

Senator BAUCUS. Mr. Secretary, why can Treasury issue a ruling that that clears up the estate tax questions regarding PIK, but not issue a ruling that clears up the income tax questions?

Mr. CHAPOTON. The income tax rules are, I think all parties who look at it agree, quite clear. If value is made available or granted to a taxpayer either in cash or in the form of a valuable commodity, that is taxable income. There is just no avoidance of that.

Senator BAUCUS. Even though the farmer has set aside certain land and cannot grow crops on that land?

Mr. CHAPOTON. That probably exacerbates the question from his standpoint, because that is some consideration he has contributed to the earning of the income.

Senator BAUCUS. So that I understand the Treasury position clearly, does Treasury support the policy underlying the legislation we are considering today—that is, that income should not be realized when farmers receive PIK commodities?

Mr. CHAPOTON. We are in agreement with the policy that the law should be changed to prevent that, yes.

Senator BAUCUS. Does the Treasury have a position regarding whether a farmer should have a right to an election?

Mr. CHAPOTON. Yes, Senator Baucus. We think it should not be an elective process, that if it is under one of these programs it simply ought not to be taxable. It ought to have a zero basis, which will build in, under our normal rules, taxable income when the commodities are disposed of or used——

Senator BAUCUS. Regarding the estate tax, what is the Treasury's position regarding the estate tax consequences of participation in other set-aside provisions, specifically, the paid diversion and nonpaid diversion provisions the 20 percent set-aside provision program?

Mr. CHAPOTON. I was going to get to that in response to your first question. That is a closer question. The two issues involved there are whether when you set aside property for one of these programs it nevertheless can be considered property used in the farming business; and second, whether that farmer who set aside his property is materially participating in the farming business.

The question has never been addressed, for some reason, under existing law, even though it certainly could have arisen under prior law. Since it has now arisen, a lot of thought and study has gone into the question. I reserved opinions when I testified before the House side on the case where 100 percent of the property was set aside, but said except in that case the law seems pretty clear that those two tests are met.

Now the IRS has gone further and said, even in the 100 percent set-aside case they think, since these are temporary programs by nature, that the farmer is involved, is materially participating, in farming operations. Indeed, it is because he is a farmer that he is involved in this program. He cannot use the property for other purposes, and that property can correctly be considered used for farming purposes.

The question in the estate tax provision, the policy of the estate tax provision is to limit the value of the property to its use as farmland, and since it cannot be used for other purposes it seems consistent with that policy.

Senator BAUCUS. Will tomorrow's release address the set-aside provisions with respect to 2032(A)?

Mr. CHAPOTON. Yes, correct.

Senator BAUCUS. So it will address not only the PIK provisions, but also the set-aside provisions?

Mr. CHAPOTON. Correct. The earlier program, the set-aside provision as well as the PIK program.

Senator BAUCUS. Does Treasury have any position about whether we should address that question in the legislation we are considering today?

Mr. CHAPOTON. We don't have any concerns if it is addressed. We do not think it is necessary.

Senator BAUCUS. But again, just so that the record is clear, will tomorrow's press release cover both PIK and the set-aside?

Mr. CHAPOTON. Yes, the press release itself will address both.

Senator BAUCUS. What's the Department's position regarding the duration of any legislation we pass? Should it last 1 year, 2 years, or be indefinite? I think the House bill had a limit of 1 or 2 years.

Mr. CHAPOTON. The House had 1 year, this year's crop plus the winter wheat crop is covered. We have proposed—the Agriculture Department is proposing a 2-year program. We have proposed the income tax treatment for the duration of the program, but we did not object if the committee over there had some concerns about misuse of the tax rules and suggested it be limited to 1 year and then revisited again this fall. We did not object because it seemed clear the Congress would roll it over and extend the treatment with the program unless some problems that none of us foresaw developed.

Senator BAUCUS. On any of the items we have discussed, does the USDA have a contrary view?

Mr. CHAPOTON. I think not. I am sure they would rather have a 2-year program. We all wanted a 2-year tax rule initially.

Senator BAUCUS. Thank you very much.

Senator WALLOP. I think along those lines it is important, really, to point out that if PIK works there will not really be any need for a sunset. It will do it itself, if in point of fact it does reduce the overpowering accumulation of surpluses in the country. The provisions are really provisions more to salve our conscience than effectively deal with the problems presented to us.

Mr. CHAPOTON. We can anticipate none of the problems the chairman of the House subcommittee was concerned about. But it was certainly an acceptable limitation if he wished to impose it.

Senator WALLOP. Yes. I am just concerned about it because we are in the middle of a situation in which it is grossly irrelevant. But I would hope that your answers would note you made mention that it was a special rule for a special situation. It is a special situation, and if it is an effective and creative plan and it works, we will be out the other side of it quite quickly. If it does not work we

will be out the other side of it quite quickly anyway, because the pressures to find something that will function will be too great.

I really do not worry about it.

Mr. CHAPOTON. I might say, Mr. Chairman, in that regard the antiabuse provision that was inserted by the House probably addresses any type of question that caused the 1-year limitation to be put in in the first place.

Senator WALLOP. But I do not really see how anybody—I do not see how you can get into that situation of abuse, I guess is what I am saying. Anyone that is buying into agricultural land for the purpose of PIK has a pretty strange accountant. It just is not going to work.

Does anyone have any further questions of the Secretary?

[No response.]

Thank you very much for coming up this afternoon.

Next is Deputy Secretary Richard Lyng, who is accompanied by Mr. Ramsey Barnes, general counsel; Mr. Wilmer Mizell, Assistant Secretary for Congressional and Public Affairs. How are you?

Mr. LYNG. Assistant Secretary Mizell was unable to come. The gentleman with me is not Wilmer Mizell. This is Jim Barnes, our general counsel.

Senator WALLOP. Thank you very much, and please proceed.

STATEMENT OF RICHARD E. LYNG, DEPUTY SECRETARY, U.S. DEPARTMENT OF AGRICULTURE ACCOMPANIED BY JAMES A. BARNES, GENERAL COUNSEL, USDA

Mr. LYNG. My colleagues and I appreciate the opportunity to visit with you, Mr. Chairman and other members of the subcommittee. I would like to compliment you and the subcommittee for the promptness with which you are trying to come to grips with what turned out to be a problem after we introduced the concept of a PIK program.

The Department of Agriculture is giving this program top priority. There appears to be a broad consensus the PIK program is the most effective tool available to deal with the excessive supply problem currently facing agriculture. Because of the serious problem facing agriculture, we have had to move quickly to implement this program. We cannot wait another year and let the surpluses continue to build.

Accordingly, President Reagan introduced the PIK program on January 11, 1983. Signup began on January 24 and will end on March 11, 1983. As signup has proceeded, some producers have raised concerns regarding taxation of PIK commodities. Our attorneys and policy officials have been working with the Treasury and IRS officials in an effort to clarify this issue.

Unfortunately, this matter cannot be resolved administratively. Unless current law is changed, farmers will likely have to pay income taxes in the year in which the PIK commodities are made available, not when the farmers choose to sell them. For many farmers this would mean income tax liability for two crops within one tax year.

Since we are nearing the end of signup, it is crucial that tax legislation be enacted that would treat the payment in kind commodities for tax purposes in the same manner as normal production. This would not provide for tax avoidance. It would just mean that income tax liabilities would be applied to the tax year in which the farmer chooses to sell his PIK commodities.

Otherwise, payment in kind program participation could be seriously reduced and overall program effectiveness limited. Therefore, we request that the Congress expedite legislation that would effect this change.

Now, in my testimony, Mr. Chairman, I have a description of the payment in kind program. I would like to submit that for the record, but I think that the members of this subcommittee are already familiar with the PIK program.

Senator WALLOP. By all means, we would appreciate it. Thank you.

Mr. LYNG. I would simply like to urge that Congress move ahead with a simple change in the tax law so that farmers will not be taxed until the payment in kind commodities are sold. We believe that this action will encourage farmers to participate in the PIK program, which in turn will help balance supply with demand and draw down stocks that currently overhang farm commodity markets.

This action will be an important step in restoring prosperity to our Nation's farmers and ranchers and in reducing future farm program costs.

Thank you, Mr. Chairman. That concludes my testimony. I would be happy to try to answer any questions.

Senator WALLOP. Thank you very much, Dick.

Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Lyng. I appreciate your participation in this. In fact, let me go beyond that and say I appreciate the USDA working with IRS over a long period of time prior to the introduction of these bills trying to get this worked out through regulation, and I am sorry that the law does not permit that. But at least your efforts in that direction are to be commended, and I hope you will tell Secretary Block that all of the farmers appreciate that.

Has enrollment in the PIK program declined because of uncertainty about the tax consequences of participating in PIK?

Mr. LYNG. We do not know, Senator Grassley, what the enrollment in the PIK program is. This has been kept confidential at the local county offices. We know that there has been some concern. We hope we have alleviated that by the actions that we have taken and the actions that you have taken, and the subcommittee in the House.

I think there must be a generally good understanding that a real effort is being made to correct this, and I think in anticipation, there is a great deal of interest in what goes on in the next few days.

Senator GRASSLEY. What if we come up a few days short of actually getting it signed by the President by March 11? Do you think that will make a big difference?

Mr. LYNG. It would be hard for me to be precise on that, but I think the fact that we had a unanimous decision from the House Subcommittee, and within the next few days we hope to have other actions, that I think will encourage farmers and they will participate.

Senator GRASSLEY. Could the USDA do something in the way of public information to say, 3 or 4 days before the final signup, that it looks as though legislation is moving along and it is going to be—it looks like it could be passed, so that no one loses an opportunity over what is just about completed but yet an unfinished job?

Mr. LYNG. We have done some of that and we will continue. I can assure you, Senator Grassley, and I am sure you know this, there is great interest in this out in the country and they are watching these actions. We do not really have to say much. I think the farmers are watching this very, very closely.

Senator GRASSLEY. Do you remember the question I asked Assistant Secretary Chapoton about the tax treatment of advanced deficiency and diversion payments? Along that line, has the USDA sought any clarification from Treasury on the tax consequences of receiving these advance payments, whether or not they be income from 1982 or 1983?

Mr. LYNG. Yes, we have talked with both Internal Revenue and the people at Treasury. We have had excellent cooperation and we are looking forward to their decisions on those matters.

Senator GRASSLEY. All right. Those are all of the statements I have.

Senator WALLOP. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Could you tell us the amount of tax an average farmers who participate in the PIK program will have to pay if these clarifying actions are not put into effect on an annual basis?

Mr. LYNG. Senator Baucus, I do not know. We could not give the figure on how much taxes, but I would have to say that if the farmers felt they had to pay taxes on two crops in 1 year participation would be so low, it would not be that they will be paying a lot of taxes, it would simply be they would not participate in the PIK program.

Senator BAUCUS. The figures I have received from the Joint Tax Committee show that for a 1 year PIK, the total income tax effect would be negative $476 million and the total estate tax effect would be negative $615 million. Thus, the total would be about $1 billion a year for 1984.

On another point, will the grain a farmer receives come within the $50,000 payment limitation?

Mr. LYNG. No.

Senator BAUCUS. Have you stated that clearly so that everyone knows it?

Mr. LYNG. It has been decided that the payment in kind is not subject to the $50,000 limitation, and we must recognize that we are asking people to take well over 50,000 dollars' worth of their crop output out of production, and we could not possibly ask them to do that without exceeding the $50,000 payment limitation on the payment in kind.

Senator BAUCUS. Has the Department so publicly stated?

Mr. LYNG. Yes, we have done so, because it is a crucial issue.

Senator BAUCUS. What date was that?

Mr. LYNG. Right at the outset this was a question that came up even before the formal announcement on some crops, particularly for some wheat areas, cotton and rice, but also for some corn and sorghum. But in cotton and rice particularly, the question of the payment limitation was immediately raised because of the average size of the farms.

Senator BAUCUS. I ask that question because there is some confusion still in Montana. Perhaps word did not get out there. But for your information, there is some confusion in that State. I appreciate what you are saying today. That helps clarify it.

In some parts of the country, high protein wheat gets a premium, and in other parts of the country you have different grades of wheat. Given this situation, will the warehouse receipts a farmer receives under the PIK program reflect the type of crop, for example the grade of wheat, the farmer sets aside?

Mr. LYNG. This will all be done as close to home as we can. As a matter of fact, in some cases the commodity will be a commodity which the farmer produced himself in previous years. But we cannot do that in many cases and in some commodities there will be a difference in the grade or quality of the payment in kind compared with that produced. But an effort will be made to equalize that in value.

Senator BAUCUS. Will every effort be made to reflect commensurate value grades?

Mr. LYNG. Very definitely.

Senator BAUCUS. Why not include barley in the program?

Mr. LYNG. Barley is not included in the program. Most crops are not included in the program. It is a relatively small number that are. It is an absolutely small number that are.

The reason barley is not included is we do not have enough barley in Government hands to make a payment program work.

Senator BAUCUS. You do not have that much surplus?

Mr. LYNG. There is a CCC surplus but it is not large. We think barley will benefit in time from the payment in kind program in the corn program and the sorghum program.

Senator BAUCUS. I realize the questions I now am asking are not within the formal jurisdiction of this committee, but I want to take advantage of this opportunity to learn more about the PIK program. To continue, is the Department thinking of announcing, say, a 2-year PIK program and announcing the program early, so that farmers could plan ahead a little more?

Mr. LYNG. So much depends, Senator Baucus, upon the crop and the weather that it is impossible. It would be improper, I think, and irresponsible for us to announce a 2-year program because we would not know really what the situation in terms of surpluses would be in the second year. But assuming a second year is needed we will make every effort to announce the program early, well in advance of planting time, even for early plantings of winter wheat.

Senator BAUCUS. By what date do you expect to?

Mr. LYNG. I would hope we could do so in late summer, no later than September 15.

Senator BAUCUS. OK. I have no further questions. Thank you very much.

Mr. LYNG. Thank you.

Senator BAUCUS. Thank you, Mr. Chairman.

Senator WALLOP. Thank you, Max.

Mr. Secretary, under the legislation that the House Subcommittee has marked up there is a restriction in the estate tax section that property, to continue to qualify for the current use valuation, must be devoted to a conservation use. And my question to you is, is not that restriction already imposed by USDA as a condition of participation in PIK?

Mr. LYNG. Yes, that is a part of the payment in kind program. Land taken out of production must be dedicated to conservation use. And I personally have long felt that that in itself made the land continue to be a farm, and we are very pleased with the statements that have been made on the question of estate taxes by the Department of the Treasury.

Senator WALLOP. Yes, I must say, so was I. I think that is very reassuring. As announced, I believe the administration said that the PIK program was for 1 year, but contemplates it could last about 2 years. Assuming some moderate participation in the program and normal production, as a practical matter how long could you envision the PIK program lasting?

Mr. LYNG. I cannot envision it lasting longer than 2 years. It could be after 1 year, depending entirely on what kind of a growing season we have this year. If we have a good one I suspect we would have to have another year of PIK because of the size of the surpluses we have. But at the end of the second year I should think that we would have things in very good control.

Senator WALLOP. It is interesting. As we sit here with people worrying about estate taxes and everything, if it works even halfway well it strikes me that we will have less outgo in terms of storage and less outgo in terms of loans, and more income in terms of crops that are available to be sold, and fewer deductions on those things. It seems to me it is one of those few programs that comes along once in a while that has a chance to really work.

And it is difficult, I know. I say it has a chance because I believe everyone's purpose in mind is that. It is just always difficult to forecast what happens. I hope that it does work out, and certainly I and my staff appreciate the cooperation we have had with both the Department of Agriculture and the Department of Treasury trying to work these things out.

Are there any other questions?

Senator BAUCUS. Following up generally on that same point, does the Department have a view whether we should have a 1- or 2-year PIK tax bill?

Mr. LYNG. Yes, Senator Baucus. We would prefer, as has been earlier stated, that the bill be a 2-year bill.

Senator BAUCUS. Why?

Mr. LYNG. We would just like to be able to have the second year of PIK without having to come back to the Congress.

Senator WALLOP. I think the answer they gave you about planting next year's crop is one reason to have it. If they had to come back here in August——

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Senator BAUCUS. I agree. Frankly, I am trying to encourage the Department to establish a 2-year program.

Formality aside, do you think the Department will eventually recommend a 2-year program?

Mr. LYNG. Anticipating normal weather, making that assumption, I would then make the prediction that we would have a second year of at least some part of a payment-in-kind program.

Senator BAUCUS. Thank you, Mr. Lyng.

Thank you, Mr. Chairman.

Senator WALLOP. Senator Dole, do you have any questions?

Senator DOLE. No, I have no questions except one general question. This is not on the PIK program, and maybe it has already been raised, but I think what we do not want to happen to this program is have someone rip it off for a good sum of money. There was a story in the Washington Post last week. Have you made inquiry into that?

Senator GRASSLEY. No, I have not.

Senator DOLE. I am not here picking on any commodity group, but it is talking about triple profits for western cotton farmers. Now, it just takes about two or three stories like that to kill the PIK program, and that may have been the purpose of it. I am not sure.

I talked to Secretary Block about the general thing, whether it is in the wheat area, the corn area, or the cotton area, or any other area. I assume there will be some safeguards in the program not to let that happen.

Mr. LYNG. Yes. That story, unfortunately, showed a lack of understanding of the economics.

Senator DOLE. Yes, they didn't have all of the factors cranked into the story. That happens quite often.

Mr. LYNG. We do not see any chance for any big ripoffs in this program. We must get the participation, Senator Dole, of the large producers if we are going to get the reduction in the production we need. And we must keep in mind that we are not making any payment to a producer who has not reduced his production by a base larger than the amount we pay. So that even though the payment may be very large, that large producer has given up an even greater production.

And I think it is a generous program for all. We had to make it a generous program to get participation. But in no way is it a ripoff program.

Senator DOLE. We have had the same argument on that on payment limitations over the years. If you are going to get the larger producers to participate, you have to have a higher payment limitation. And even though all the statistics show, or used to show, that 10 percent of the farmers got 90 percent of the benefits or whatever, maybe that is not the way it should work, but if you are going to reduce production—and I am certain that the Department is alerted to it, and I know you are, Mr. Secretary. But those kinds of stories do not help the farmers' image or the image of Congress in approving such a program.

And you probably also addressed the question, if we do not get this all done by March 11 is there anything we can do to assure farmers that it will happen?

Mr. LYNG. The action of this committee in meeting and the fact that you are going to hold an early markup, we are hoping all of these things will move it along favorably, and the fact that we have a simple bill that does not have a host of amendments to complicate it, all of this will be very helpful.

The fact that we have a unanimous vote of a subcommittee in the House tells people, I think, that Congress has an interest in seeing this, and I think we will get good participation if that continues.

Senator DOLE. Right. And I think farmers know there is broad support, in fact almost unanimous support. That might encourage the signup.

Mr. LYNG. I am sure that is true, and we will see to it that they are told that.

Senator DOLE. Thank you. Good.

Senator WALLOP. I might just say that I appreciate your words regarding the Washington Post article. You said it showed an unfortunate misunderstanding of the PIK program. I would like to think you are right. When I read it here, I think it is a very unfortunate, spiteful understanding of it, trying to shoot down something on purpose before it gets there.

If you read it, there is no way that the conclusions this story draws can be drawn from the information he already possessed. I just hope that we could expect a little more from a newspaper that prides itself on being one that is supposed to understand some of the problems at issue, particularly a segment of the industry such as agriculture that is suffering now.

You can make any spiteful remark you can about any segment of this economy, but it is not very helpful when it is down there and suffering. So I think your words were softer than mine would have been, and I appreciate why you said them that way, but I don't have to.

Mr. LYNG. I share your hope, Mr. Chairman, but I fear that in this particular instance it is a forlorn hope.

Senator WALLOP. Yes. Well, thank you very much, Dick. We appreciate your being here.

Mr. LYNG. Thank you.

[Statement of Richard E. Lyng follows:]

STATEMENT OF RICHARD E. LYNG, DEPUTY SECRETARY OF AGRICULTURE

Mr. Chairman, my colleagues and I appreciate the opportunity to visit with you and other subcommittee members today to discuss the Payment-in-Kind (PIK) program. The Department of Agriculture is giving this program top priority. There appears to be a broad consensus that the PIK program is the most effective tool available to deal with the excess supply problem currently facing agriculture.

Because of the serious problem facing agriculture, we have had to move quickly to implement this program. We cannot wait another year and let the surpluses build. Accordingly, President Reagan announced the PIK program on January 11, 1983. Signup began on January 24 and will end on March 1, 1983.

As signup has proceeded, some producers have raised concerns regarding taxation of PIK commodities. Our attorneys and policy officials have been working with Treasury and IRS officials in an effort to clarify this issue. Unfortunately, this matter cannot be resolved administratively. Unless current law is changed, farmers will likely have to pay income taxes in the year that the PIK commodities are made available, not when the farmers choose to sell them. For many farmers this would mean an income tax liability for two crops within one tax year.

Since we are nearing the end of signup, it is crucial that tax legislation be enacted that would treat the payment-in-kind commodities for tax purposes in the

same manner as normal production. This would not provide for tax avoidance, it would just mean that income tax liabilities would be applied to the tax year in which the farmer chooses to sell his PIK commodities. Otherwise, PIK program participation could be seriously reduced and overall program effectiveness limited. Therefore, we request that the Congress expedite legislation that would effect this tax change.

Now I would like to lay out some of the merits and basic provisions of the PIK program.

PAYMENTS-IN-KIND (PIK) PROGRAM

The PIK program calls for payments-in-kind to farmers who agree to reduce their production beyond what is called for in the previously announced 1983 programs for what, corn, grain sorghum, rice, and upland cotton. The basic concept of PIK is that farmers are offered an amount of commodity as payment for reducing additional acreage.

The PIK program has several appealing and unique features:

Production will be reduced beyond that expected under the previously announced 1983 programs for wheat, corn, grain sorghum, rice, and upland cotton, and thus bring supply back into closer balance with demand.

Stocks will be reduced at the same time that production is cut back, lessening the overhang on the market at harvest next year and enhancing the prospects for a market-led recovery in farm prices and incomes in future years.

The availability of market supplies will be maintained, signaling to exporters and importers that the United States fully intends to remain a reliable and consistent supplier when production adjustments are made. To meet our long-term export and food aid commitments, adequate reserves will be maintained.

Government outlays for domestic programs (e.g., loan volume, storage payments, deficiency payments) will decline.

The PIK program, unlike other emergency measures, is self-terminating when excessive stocks have been worked off.

Farmers will have the same or greater net returns while stocks are being reduced.

Sound conservation practices will be applied to a large amount of acreage.

Storage space problem would be lessened.

We urge the Congress to move ahead with a simple change in the tax law so that farmers will not be taxed until PIK commodities are sold. We believe this action will encourage farmers to participate in the PIK program, which in turn will help balance supply with demand and draw down stocks that currently overhang farm commodity markets. This action will be an important step in restoring prosperity to our nation's farmers and ranchers, and reducing future farm program costs.

Senator WALLOP. The next is a panel consisting of Grace Ellen Rice, the assistant director of national affairs, Division of American Farm Bureau; John S. Barr III, chairman of the Producers Steering Committee, National Cotton Council; and Dr. Bruce Gardner, professor, department of agricultural and resource economics, University of Maryland, College Park.

We welcome you all.

Grace, you may begin if you would like.

STATEMENT OF GRACE ELLEN RICE, ASSISTANT DIRECTOR, NATIONAL AFFAIRS DIVISION, AMERICAN FARM BUREAU FEDERATION

Ms. RICE. Thank you for the opportunity to present testimony today on the PIK tax bill.

The Farm Bureau represents farmers who produce virtually every commodity grown on a commercial basis in this country. Our members participate in a comprehensive policy development process at the county, State and national levels.

In January Farm Bureau members adopted a policy in support of the PIK program as a short-term solution to reduce the record large commodity stocks as well as the cost of Federal farm pro-

grams. When our members adopted this policy, they indicated that a crop swap program such as PIK should be viewed as a short-term solution implemented in conjunction with an acreage reduction program to provide adequate incentive to encourage producer participation, implemented so that all payments will go only to bona fide producers, and structured in a manner that will enhance orderly marketing.

Participation was proceeding satisfactorily until questions arose concerning the income and estate tax treatment for participants in the PIK program. The Farm Bureau is concerned that this uncertainty has caused farmers to become very reluctant about signing up in this program.

The basic problems have been well discussed—the income tax treatment and the estate tax questions. Our position is such that we support legislation both in the House and the Senate to clarify this matter and to treat commodities received in the PIK program as if they had been actually grown by the producer.

Problems about income bunching and cash flow problems for farmers who might be forced to pay taxes on two crops in 1 year have been outlined quite well. Just to summarize, we do urge the House and Senate to act quickly on this program. We would like to see it resolved by March 11.

Thank you.

Senator WALLOP. We certainly will try.

There is one thing that I would say on that. I don't mean to interrupt the panel, Mr. Barr, but I think that very early on, you will have—and by very early on, I mean the end of this week or Monday or Tuesday of next week—you will have all the indication you need to get out to your members at least whether this will go through or not.

The indication would be, if you saw the great lineup of kinds of legislation and riders Senator Dole was talking about, the bankers trying to solve their problems on this bill. I don't think that will happen, but clearly I think if you are seeing a plain bill go through, I just think in this instance it would be a pretty safe bet. The administration is for it, they designed it, so Congress has slipped in comfortably behind it. I think there could be some real confidence in getting that out.

Senator GRASSLEY. Is your organization reluctant to make some sort of prognostication based upon the fact that maybe it has moved through two committees or something, or would they be willing to put out the word that it looks like it is going to pass? Or is that going too far out on a limb?

Ms. RICE. I don't necessarily think it is going too far out on the limb. I think we have much more hope this week than we did last. After seeing the bill come out of the House subcommittee and the Finance Subcommittee hearings today, it is an indication to us that Congress could move quickly if it chooses to do so.

Senator GRASSLEY. So you would signal that to your members?

Ms. RICE. Yes.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
AND THE
SUBCOMMITTEE ON THE OVERSIGHT OF THE INTERNAL REVENUE SERVICE
SENATE FINANCE COMMITTEE
REGARDING TAX TREATMENT OF THE PAYMENT-IN-KIND PROGRAM

Presented by
Grace Ellen Rice, Assistant Director, National Affairs Division

February 28, 1983

The American Farm Bureau Federation is the nation's largest general farm organization. Farm Bureau is organized in over 2800 counties and represents farmers who produce virtually every commodity grown on a commercial basis in this country. Farm Bureau members, who now number over three million member families in 48 states and Puerto Rico, participate in a comprehensive policy development program at the county, state, and national levels.

In January, President Reagan announced a farm program designed to reduce price depressing commodity stocks and government farm program costs. Known as the Payment-In-Kind program (PIK), the plan allows farmers to reduce their acreage of wheat, feed grains, cotton, and rice by an additional amount above previously announced acreage reduction and paid diversion programs. As compensation for the reduction, the participating farmers receive commodities, rather than cash, as an incentive to participate. The "entitlement date", or time when the farmer is eligible to receive the PIK commodity, is established to correspond to the usual harvest period in each farmer's area.

Farm Bureau supports the PIK program as a short-term solution to reduce the record-large commodity stocks and the costs of federal farm programs. At the 64th annual meeting of the American Farm Bureau Federation held last month in Dallas, Texas, voting delegates of the member State Farm Bureaus adopted the following policy on the PIK program:

> We support the implementation of a "crop swap" program in conjunction with an effective voluntary acreage reduction program for the 1983 and 1984 crops of wheat, feed grains, cotton and rice to alleviate the problem of our present burdensome, price-depressing surpluses. A "crop swap" program should be:
>
> (1) Viewed as a short-term solution;
>
> (2) Implemented in conjunction with an acreage reduction program which will provide adequate incentive to encourage producer participation so that supplies can be brought into line with demand;
>
> (3) Implemented so that all payments will go only to bona fide producers;
>
> (4) Structured in a manner that will enhance orderly marketing;

(5) Coupled with an incentive program for foreign buyers; and

(6) Implemented so that acres diverted under this program will not be grazed.

The sign-up period to participate in the PIK program began on January 14 and is scheduled to end on March 11. Participation in the program appeared to be proceeding satisfactorily until questions arose concerning the income and estate tax treatment of farmers who received commodities as payments-in-kind. Farm Bureau is concerned that the uncertainty surrounding the tax treatment of PIK commodities will discourage participation in the program at a time when production cuts must be made to reduce future carryover supplies.

The Subcommittees are well aware of the two major issues in question:

(1) The possibility that the Internal Revenue Service, Department of Treasury, may treat commodities received under the program as income, and therefore taxable, in the year that the farmer has a right to receive the commodities rather than when the farmer actually sells them.

(2) The possibility that the special use valuation provisions of Section 2032A, Internal Revenue Code, may be jeopardized by a farmer's participation in the PIK program.

Bills have been introduced in both the House and Senate to clarify these issues. The legislation requires that PIK commodities be taxed in the same manner as commodities actually grown by the farmer. Without this provision farmers would be faced with paying income taxes on commodities not yet sold. The provision avoids income bunching and cash flow problems for farmers who quite likely would have no cash with which to pay income taxes prior to the actual sale of the commodities.

Just as important as the income tax provisions of the legislation are the estate tax provisions which would preserve the application of special use valuation of farmland for farmers receiving PIK commodities. Uncertainty has arisen on this point because some have questioned whether participation in the PIK program puts a farmer "at risk" as required under the qualifications for Section 2032A.

We urge the Subcommittees to review pending legislation and to act quickly to clarify the income and estate tax treatment of PIK participants by treating PIK commodities as if they had been grown by the farmer. Legislation must be passed by the Congress and signed by the President prior to March 11. If this cannot be achieved, Farm Bureau urges the leadership of the House and Senate, and the President, to make clear their intentions so that farmers may have the opportunity to make informed decisions on their production plans for 1983.

Thank you for your consideration of Farm Bureau's testimony.

Senator WALLOP. Mr. Barr, please.

STATEMENT OF JOHN S. BARR III, CHAIRMAN, PRODUCERS STEERING COMMITTEE, NATIONAL COTTON COUNCIL OF AMERICA

Mr. BARR. Mr. Chairman, I am John S. Barr, a cotton producer from Oak Ridge, La., and currently serving as chairman of the Producers Steering Committee of the National Cotton Council, in whose behalf I appear here today.

As you well know, the National Cotton Council is a central organization of the U.S. raw cotton industry, and we represent not only producers but ginners, merchants, warehousemen, cooperatives, cotton seed crushers, and also textile manufacturers from California all the way to the Carolinas.

We appreciate very much the opportunity to be here today and to submit this statement to you. Cotton producers, like others in agriculture, are under very severe economic stress. Every effort must be made to bring supplies into better balance with demand, and we as an industry are very strongly supportive of the PIK program for just this very reason.

This is also the reason we support legislation pending before this subcommittee to clarify the tax treatment of payment-in-kind commodities. By requiring all or a portion of such commodities to be considered as taxable income upon receipt rather than when sold, will jeopardize the program's success.

The reason is it would impose a substantial tax penalty on producers at a time when they are suffering from limited cash flow. Faced with the prospect of a substantial tax liability and no real income to pay the taxes incurred, cotton producers may simply not participate in the PIK program.

This means the PIK program will not achieve the needed adjustment in cotton production. Cotton prices will continue to be subject to downward pressure, the effects of which will be felt by both large and small growers, and greater Federal outlays will be triggered under the target price provision of the act, thus worsening the present difficult situation.

Further, for those producers who do choose to participate, the present tax liability, unless changed, will force them to sell their commodities upon receipt when prices are at their seasonal lows. The result, then, is to further depress prices and again trigger additional outlays under the target price provisions.

Therefore, we strongly urge the subcommittee to clarify the law to allow payment-in-kind commodities, including cotton, to be considered as taxable income upon sale rather than upon receipt.

There is also the need to clarify the law with regard to estate taxes. This has already been mentioned. Under this law, current use valuation is allowed for land that is being farmed at the time of the decedent's death and is continued in that use by the heirs. Furthermore, following the death of the principal owner of a closely held business which includes a farm, the executor may elect to pay the estate tax plus interest over a period of 15 years, but the land must continue to be farmed.

It would be desirable to amend the law to specify that land being held out of production in conserving uses, under the PIK or any

other paid diversion program, is being farmed for purposes of these two provisions of the law.

We are pleased to hear Assistant Secretary Chapoton's comments regarding the IRS ruling on this. We do think it might clarify things for it to be put in the law. Again, Mr. Chairman, we appreciate very much the opportunity of presenting our honest views to you.

Senator WALLOP. Thank you very much, Mr. Barr.

I gather that Dr. Gardner is not here, so that concludes this panel's testimony.

Senator Grassley, do you have questions?

Senator GRASSLEY. No, I think I have asked all of the questions I have. No, wait a minute. I am sorry.

What is your judgment? Do you think these tax problems have reduced the enrollment in the program? Do you have that feeling from your members?

Mr. BARR. In my opinion, I think anything that creates a gray area does. The program, as you well know, is a complicated one. It would seem to be encouraging to farmers that such a program is available to them, but anything that creates a gray area raises a question in terms of whether or not he will participate.

Our organization, as the Farm Bureau has, already indicated to our membership we feel that this problem will be corrected by law, but in order to say that it will be, it is going a little bit out on a limb.

Senator WALLOP. Mr. Barr, you have the floor. Would you care to comment on the Washington Post's article on the cotton producers?

Mr. BARR. I would certainly be happy to try to set the record straight regarding that. For the record, I think I would like to offer the testimony that Mr. Jimmy Sanford, treasurer of the National Cotton Council, gave before the House Ways and Means Committee last week.

Senator WALLOP. By all means.

Mr. BARR. As has already been indicated, the article was taken somewhat out of context. The numbers expressed in the article were expressed in the Economic Outlook for Cotton, which I also have a copy of, which I would be glad to offer for the record. Those numbers were in essence decisionmaking numbers offered to farmers. The numbers were gross receipts over variable costs.

You and I both know that variable costs are not the only costs involved in a farming operation. It was very wrongly interpreted that the receipts over variable costs were the same as net profits. That is not at all the case. When you go back and put fixed costs in and subtract them, that same $1 million net figure became a considerable loss.

I do have the figures and I would be glad to give them for the record.

Senator WALLOP. I think it would be useful to have that in the record. I think Senator Dole is correct in assessing that a few articles like that can do more harm to the program than all of the good efforts we might be able to muster combined to rescue it.

I have my own ideas, as I expressed, why I think it may have taken place, but I think it is useful to have a clear assesment of the economics of that issue. I will say this. A lot of people do not

understand that it costs money to own land. There are taxes on it, and I don't know about most people who grow cotton, whether they spend some time irrigating, and I don't know about your part of the world, but in my part of the world, the water costs you whether you apply it or not.

There are just a lot of things out there.

Mr. BARR. There is also another major figure called interest.

Senator WALLOP. Yes, the interest rates, sure, and those things remain.

Mr. BARR. Notwithstanding, there is also a certain amount of cost in keeping this land in a conserving use base.

Senator WALLOP. Yes. The other point is you are supposed to be able to make a little. In a farm economy that has been recognized as grossly ailing, the idea of it was that people could make a little money off their farm and not have them foreclosed and not have them running up on the auction block for tax money or anything else.

The purpose of it was to rescue some segments of the agricultural community that have found themselves victims of enormous crop surpluses. I don't think we should back away from the idea that people participating in this program should be able to make a living out of some of their participation. That is what we were up to. There was nothing devious about it. Straight out in front, we were up to having people make a living.

Mr. BARR. There is a certain amount of irony that we appear before you today to talk about tax issues when I don't know many farmers who would not welcome the opportunity to be facing tax problems again.

Senator WALLOP. That is, of course, one of the other sides of this program. If it works, and I really hope it does, not only do you get some revenue in, you don't have so much going out, and both of those things could be rather beneficial to both farmers and the country.

I appreciate very much your coming here this afternoon, and the information and figures you brought will be part of the record.

[The information referred to follows:]

TESTIMONY OF JOHN S. BARR, III
NATIONAL COTTON COUNCIL OF AMERICA
BEFORE THE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
OF THE SENATE COMMITTEE ON FINANCE
FEBRUARY 28, 1983

Mr. Chairman, I am John S. Barr. I am a cotton producer from Oak Ridge, Louisiana and currently serving as Chairman of the Producer Steering Committee for the National Cotton Council in whose behalf I appear today.

The National Cotton Council is the central organization of the U.S. raw cotton industry, representing cotton producers, ginners, merchants, warehousemen, cooperatives, cottonseed crushers and textile manufacturers from California to the Carolinas.

Mr. Chairman, we appreciate very much the opportunity to share with you the cotton industry's concerns regarding the tax treatment for payment-in-kind commodities received by producers.

Cotton producers, like others in agriculture, are under severe economic stress. Every effort must be made to bring supplies into better balance with demand. And, we as an industry are strongly supportive of the PIK program for just this reason.

This is also the reason we support legislation pending before this Subcommittee to clarify the tax treatment of payment-in-kind commodities. By requiring all or a portion of such commodities to be considered as taxable income upon receipt rather than when sold would virtually eliminate any chance for the program's success.

The reason is that it would impose a substantial tax penalty on producers at a time when they are suffering from limited cash flow. Faced with the prospect of a substantial tax liability and no real income to pay the taxes incurred, cotton producers, particularly larger producers, will simply not participate in the PIK program.

This means the PIK program will not achieve the needed adjustment in cotton production; cotton prices will continue to be subject to downward pressure -- the effects of which will be felt by both large and small growers; and greater federal outlays will be triggered under the target price provisions of the Act, thus worsening the present deficit situation.

Further, for those producers who do choose to participate, the present tax liability unless changed will force them to sell their commodities upon receipt when prices are at their historical season lows. The result then is to further depress prices and again trigger additional outlays under the target price provisions.

Therefore, we strongly urge this Subcommittee to clarify the law to allow payment-in-kind commodities, including cotton, to be considered as taxable income upon sale rather then receipt.

There is also the need to clarify the law with regard to estate taxes. Under present estate tax law, current use valuation is allowed for land that was being farmed at the time of the decedent's death and is continued in that use by the heirs. Furthermore, following the death of the principal owner of a closely-held business, including a farm, the executor may elect to pay the estate tax, plus interest, over a period of fifteen years. But the land must continue to be farmed. It would be desirable to amend the law to specify that land being held out of production in conserving uses under the PIK or any other paid diversion program is being farmed for purposes of these two provisions of law.

Again, Mr. Chairman, we appreciate very much this opportunity to share our industry's views.

TESTIMONY OF JAMES H. SANFORD
NATIONAL COTTON COUNCIL OF AMERICA
BEFORE THE SELECT SUBCOMMITTEE ON REVENUE MEASURES
OF THE HOUSE COMMITTEE ON WAYS AND MEANS
FEBRUARY 23, 1983

Mr. Chairman, I am James H. Sanford. I am a cotton producer from Prattville, Alabama and currently serve as Treasurer for the National Cotton Council in whose behalf I appear today.

The National Cotton Council is the central organization of the U.S. raw cotton industry, representing cotton producers, ginners, merchants, warehousemen, cooperatives, cottonseed crushers and textile manufacturers from California to the Carolinas.

Mr. Chairman, we appreciate very much the opportunity to share with you the cotton industry's concerns regarding the tax treatment for payment-in-kind commodities received by producers.

First, however, I would like to set the record straight regarding recent press reports describing how the PIK program will benefit certain large cotton producers.

We are aware, of course, that an article which appeared in the Washington Post earlier this week has raised some questions. According to that article, which cited a study prepared by the National Cotton Council, the payment-in-kind program will -- and I quote -- "allow some large cotton growers in the West almost to triple 1983 profits to more than $1 million per farm..."

This simply is not true. The error, I'm sure, was the result of an oversight -- which, unfortunately makes a tremendous difference in the actual picture.

The Council study, which was contained in a special report entitled The Economic Outlook for U.S. Cotton, -- and I have a copy with me -- represented an attempt to help cotton producers identify their options under various farm programs and to enhance their decision-making.

The reason is that it would impose a substantial tax penalty on producers at a time when they are suffering from limited cash flow. Faced with the prospect of a substantial tax liability and no real income to pay the taxes incurred, cotton producers, particularly larger producers, will simply not participate in the PIK program.

This means the PIK program will not achieve the needed adjustment in cotton production; cotton prices will continue to be subject to downward pressure -- the effects of which will be felt by both large and small growers; and greater federal outlays will be triggered under the target price provisions of the Act, thus worsening the present deficit situation.

Further, for those producers who do choose to participate, the present tax liability unless changed will force them to sell their commodities upon receipt when prices are at their historical season lows. The result then is to further depress prices and again trigger additional outlays under the target price provisions.

Therefore, we strongly urge this Subcommittee to clarify the law to allow payment-in-kind commodities, including cotton, to be considered as taxable income upon sale rather than receipt.

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Again, Mr. Chairman, we appreciate very much this opportunity to share our industry's views.

The report identified 3 options: One, not participate in any farm program. Two, participate only in the previously announced 20 percent acreage reduction program. And, three, participate fully in both the 20 percent acreage reduction program and the recently announced payment-in-kind or PIK program.

In evaluating these three options, the report made clear that -- and I quote -- "only variable costs are used in comparing alternatives, since practically all fixed costs are incurred regardless of the alternative chosen." Thus, the report for each option shows only net returns over variable costs, not net profits. To calculate net profits, one would have to go one step further and deduct fixed costs.

Unfortunately, the Post story assumed net returns over variable costs were equivalent to net profits. While an oversight, again, this had a tremendous impact on the end result. For when fixed costs are included in the equation, which according to USDA amount to over $1.5 million for a 5000 acre cotton farm, instead of a net profit of over $1 million under the PIK program as cited in the Post article -- the actual result is a loss of over $400,000. Using the same example, by not participating in the PIK program, that same producer faces a potential loss of over $1.1 million.

We have communciated with the Washington Post in this regard and provided the with additional information. And we believe, like us, they are anxious to set the record straight..

What the PIK program does with regard to cotton is not [illegible] profits but it does provide a means for avoiding disastrous losses while we go through this difficult period of adjustment. This underscores the very importance of the program. Cotton producers, like others in agriculture, are under severe economic stress. Every effort must be made to bring supplies into better balance with demand. And, we as an industry are strongly supportive of the PIK program for just this reason.

This is also the reason we support legislation pending before this Subcommittee to clarify the tax treatment of payment-in-kind commodities. By requiring all or a portion of such commodities to be considered as taxable income upon receipt rather than when sold would virtually eliminate any chance for the program's success.

NATIONAL COTTON COUNCIL OF AMERICA

EXECUTIVE BUILDING / 1030 FIFTEENTH STREET, N.W. / SUITE 700
WASHINGTON, D.C. 20005
TELEPHONE: (202) 833-2943

February 22, 1983

Mr. Ward Sinclair
The Washington Post
Washington, D. C. 20005

Dear Mr. Sinclair:

Your article on PIK cotton that appeared in the Post on Monday, February 21, indicated that you misinterpreted the term "net over variable costs" as "profit."

The Council's economic report, which evidently was the basis of your story, stated on page 16 that, in order to simplify the examples, "only variable costs are used in comparing alternatives, since practically all fixed costs are incurred regardless of the alternative chosen." The report was made to producers and other cotton industry leaders -- who are well aware of these fixed costs -- simply to help them understand how to make a choice among the cotton program options available to them.

If our intention had been to show the potential net profit from the three options, fixed costs would have been subtracted from "net over variable costs." In view of your article, we have done this on the attached sheets, using USDA estimates for fixed costs. It shows that all three alternatives resulted in a net loss ranging from $1.1 million for western growers who choose to stay out of the program to more than $400,000 for full participants. The example for smaller growers also shows a loss for all options.

While the PIK program does provide stronger incentives for almost all growers to participate in acreage reduction programs, the net profit analyses confirm the difficult economic problems currently confronting all cotton farmers and the need for programs such as PIK.

I hope you'll want to write a follow-up story to give your readers the correct impression.

If clarification is needed on this matter or you care to check information directly with the source on future articles, our office in Memphis (901/274-9030) or Washington (202/833-2943) will be glad to be of assistance.

Sincerely,

Earl W. Sears

Earl W. Sears
Executive Vice President

EWS:fw

WASHINGTON POST FEBRUARY 21, 1983

PIK Could Spell Triple Profits for Some Western Cotton Farmers

By Ward Sinclair
Washington Post Staff Writer

The Reagan administration farm surplus reduction program will allow some large cotton growers in the West almost to triple 1983 profits to more than $1 million per farm, according to the nation's leading producers group.

The prospect of a bonanza for farmers who take surplus federal cotton as payment-in-kind for not planting is outlined in an economic outlook paper circulated by the National Cotton Council.

By this estimate, a high-yield, 5,000-acre farm in California or Arizona could make at least $1 million in profit by joining the program, compared with the $368,000 it would earn by remaining in full production.

A 500-acre cotton farm in lower yielding areas of the South, the study showed, could make $68,000 profit by enrolling, compared with the $28,000 it could make by staying out.

Council economists concluded that the profit estimates make "a strong case" for participating in the federal giveaway announced last month by President Reagan. The payment-in-kind (PIK) program is designed to reduce surpluses of wheat, corn, sorghum, rice and cotton, and improve prices in the hard-hit farm economy.

By shrinking production, the government also hopes to reduce its bills for acquiring and storing surplus commodities.

Although potential profit for growers of other crops is less clear, the council's cotton data underscores Agriculture Secretary John R. Block's belief that the PIK program could succeed unless made sweet enough to attract farmers.

Farm organizations and farm state legislators generally have supported the program, agreeing with Block's assessment that, while it cuts clash with his free market philosophy, it is the only workable tool to bring supply back in line with slumping demand.

But some legislators, among them Rep. Thomas A. Daschle (D-S.D.), have complained that PIK is too generous. "Geezum!" one congressional aide asked last week. "Can you imagine how the Republicans would have clubbed the walls if Bob Bergland [Block's Democratic predecessor] had proposed this PIK program?"

Although they provide no figures, Department of Agriculture officials say farmers have been signing up briskly, with a flurry expected as the March 11 deadline nears.

A farmer may elect not to participate in any federal programs. If he wants to participate, he could choose either USDA's 20 percent acreage reduction program or the PIK, which would remove half of the farm from production.

A PIK participant who agrees not to plant on up to 50 percent of his land will be given a commensurate amount of federal surplus, which he can then lease or sell.

Cotton farmers, for example, will get 80 percent of the crop they would have expected to grow. That is, a farmer who might have produced 500 bales of cotton would get 400 bales from federal stocks.

Percentages are the same for other PIK crops except wheat, which is 90 percent. The more attractive wheat figure was chosen because winter wheat, about three-fourths of the U.S. crop, had been planted by the time Reagan announced the program. The cotton council's calculations show that, even with 80 percent payment-in-kind, there is big profit potential in PIK.

A farmer's production costs go down by about half, he still receives a direct cash subsidy of up to $50,000 in "deficiency" payments and he can sell the PIK cotton that he did not grow.

The high profit potential for the big growers in the West is related to far higher per-acre yields, achieved through irrigation and a longer growing season. Their size, the demand for their top-quality fiber and federal regulations in the past have discouraged participation in acreage reduction programs.

Last year, for example, only half of the planted acres in the West were enrolled in USDA's limited acreage reduction program. But a USDA waiver of the 50,000 subsidy limit, decreeing that commodities are not the same as cash, is expected to draw more acreage into the PIK program.

The big western farmers could profit in another, unanticipated way from the PIK program. Heavy rain and snow melt already have flooded thousands of acres in California and the situation is expected to worsen, precluding considerable cotton planting.

But the PIK formula is based on past years' acreage averages, so those farmers facing inundation and probable income loss will be able to receive PIK cotton as if they had intended to plant in 1983.

The PIK program, particularly as it applies to the West, is not entirely popular with the cotton industry.

The American Cotton Shippers Association, for example, has complained to Block and to Congress that the PIK will disrupt the market.

In a recent letter to Block, Samuel T. Reeves of Fresno, president of the association, said that the in-demand "Acala" type cotton grown in the San Joaquin Valley should not have been included in the PIK.

Example I

Base acreage = 500 acres
Actual yield = Program yield = 500 pounds/acre
Market price = PIK value = Loan level = 55 cents/pound

	COTTON PROGRAM ALTERNATIVES		
	(A)	(B)	(C)
	Non-Complier	20% Complier	20% + 30% Complier*
Planted Acreage	500	400	250
Market Revenue	$137,500	$110,000	$68,750
Deficiency Payment 1/	--	$42,000	$26,250
PIK Payment	--	--	$33,000
Revenue Potential	$137,000	$152,000	$128,000
Variable Cost 2/	$108,300	$86,640	$54,150
Conservation Cost 3/	--	$2,500	$6,250
Net Over Variable Costs	$29,200	$63,860	$67,600
Fixed Cost 4/	$78,525	$78,525	$78,525
Net Profit (Loss)	($49,325)	($14,665)	($10,925)

1/ Assumes deficiency payment = 21 cents/pound
2/ Cost/acre = (USDA Beltwide estimate) - (ginning charges)
= $266.91 - $50.31 = $216.60
3/ Cost/acre = $25.00
4/ Fixed cost per acre = machinery ownership cost ($105.13) + farm overhead ($10.54) + composite land allocation using aquisition value ($41.38) = $157.05 (USDA Beltwide estimate). This excludes management costs, estimated by USDA to be $38.26 per acre.

REFERENCE: Economic Research Service, USDA. Costs of Producing Selected Crops in the United States -- Final 1979, 1980, and Preliminary for 1981. Table 52.

Example II

Base Acreage = 5,000 acres
Actual yield = Program yield = 1,000 pounds/acre
Market price = PIK value = loan level = 55 cents/pound

	COTTON PROGRAM ALTERNATIVES		
	(A)	(B)	(C)
	Non-Complier	20% Complier	20% + 30% Complier
Planted Acreage	5,000	4,000	2,500
Market Revenue	$2,750,000	$2,200,000	$1,375,000
Deficiency Payment 1/	--	$50,000	$50,000
PIK Payment -- 80%	--	--	$660,000
-- 50%	--	4/	$257,813
Revenue Potential	$2,750,000	$2,250,000 4/	$2,342,813
Variable Cost 2/	$2,382,100	$1,905,680	$1,191,050
Conservation Cost 3/	--	$1,563	$62,500
Net Over Variable Costs	$367,900	$342,757 4/	$1,089,263
Fixed Cost 5/	$1,503,500	$1,503,500	$1,503,500
Net Profit (Loss)	($1,135,600)	($1,160,743)	($414,237)

1/ Assumes deficiency payment = 21 cents/pound
2/ Cost/acre = (USDA estimate for West) - (ginning charges)
= $586.59 - $110.17 = $476.42
3/ Cost/acre = $25.00
4/ Since 937.5 of the acres removed from cotton may be planted with other commercial crops, these figures understate the revenue potential.
5/ Fixed cost per acre = machinery ownership cost ($178.30) + farm overhead ($16.63) + composite land allocation using aquisition value ($105.77) = $300.70 (USDA estimate for West). This excludes management costs, estimated by USDA to be $78.15 per acre.

REFERENCE: Economic Research Service, USDA. Costs of Producing Selected Crops in the United States -- Final 1979, 1980, and Preliminary for 1981. Table 56.

The Economic Outlook for U.S. Cotton

1983

Prepared by
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Joseph Wyrick, Agricultural Economist
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OUTLOOK SUMMARY

GENERAL ECONOMY

The near term outlook is dominated by a global recession which is threatening economic and political stability the world over. Real economic growth was very modest in 1982, averaging less than 1 percent in the major industrial nations and less than 2 percent in the developing nations.

The prevailing consensus is that most world economies will lag improvements in the U. S. economy by several months. This implies that the U. S. will have to lead the way out of recession without initially depending on significant growth in export demand.

With regard to prospects for an improving U. S. economy, it must be remembered that the Reagan administration's economic recovery program has always consisted of four basic components: tax reform, budget restraint, monetary restraint and regulatory reform. These components are highly inter-related, so that failure to achieve any one of them will inevitably force alterations in the others. Clearly the limiting component going into 1983 is the size of the federal budget deficit. Unless substantive (rather than cosmetic) reductions are made in the growth potential of the major federal budget components during 1983, it is easy to predict that wholesale changes in the economic program will eventually be required.

Some encouraging symptoms of an improving domestic economy include increased housing starts, a rising stock market, lower international exchange rates for the dollar, growing consumer confidence, and a uptrend in the index of leading economic indicators. Even more encouraging are four fundamental developments which offer a more solid basis for economic recovery: declining inflation, growing productivity, declining interest rates, and increasing real

disposable income. In many ways, dramatic progress has been made which can provide a basis for achieving a stable, sustained economic growth.

COTTON INDUSTRY

The recessionary demand for textiles has met with two successive years of large global supplies of cotton, the result being a serious supply/demand imbalance in 1982-83 (see exhibit below). At the beginning of the 1982-83 crop year U. S. stocks had reached 6.6 million bales. Domestic production totaled 12 million bales and, with domestic mill use estimated at 5.4 million bales and exports around 5.0 million or a little less, ending stocks are expected to be at least 8.4 million bales on July 31, 1983.

COTTON SUPPLY/OFFTAKE
(Mil. 480-lb. Bales)

	1982-83 Estimate*	1983-84 Projection
UNITED STATES		
Beginning Stocks	6.6	8.4
Production	12.0	9.5
Supply	18.7	17.9
Domestic Mill Use	5.4	5.8
Exports	5.0	6.0
Offtake	10.4	11.8
Ending Stocks	8.4	6.1
FOREIGN		
Beginning Stocks	21.1	20.6
Net Imports	5.0	6.0
Production	55.7	56.5
Supply	81.8	83.1
Offtake	61.2	62.2
Ending Stocks	20.6	20.9
WORLD		
Beginning Stocks	27.7	29.0
Production	67.7	66.0
Supply	95.4	95.0
Offtake	66.6	68.0
Ending Stocks	29.0	27.0

*From USDA. Ending stocks may not equal difference between supply and offtake due to cotton that is "unaccounted for."

Foreign stocks of cotton began 1982-83 at 21.1 million bales and are expected to decline a half million bales to 20.6 million by the end of this marketing year. But the U. S. stock build-up is expected to make world stocks grow from 27.7 million bales to 29.0 million.

In spite of potential for large errors, cotton industry policy-makers must have the best possible supply/offtake projections for the coming crop year. To help fill this need, the exhibit on page 2 also contains plausible mid-point numbers for the United States, all foreign countries and the world. The U. S. cotton crop is projected to be about 9.5 million bales. This would make the total U. S. supply 17.9 million bales, down about 700,000 bales from the current supply. Assuming the return of modest growth in U. S. consumption, domestic mill use is pegged at 5.8 million bales. In the foreign world, projected increases in consumption and stock requirements outstrip production increases, accommodating a modest increase in U. S. exports to 6.0 million bales. The result would be to reduce stocks to about 6.1 million bales by July 31, 1984. The implication is that another year of supply reduction programs will be necessary to bring U. S. stocks down to an acceptable level.

The effect of these domestic and foreign scenarios is to lower world cotton stocks by about 2 million bales during the 1983-84 marketing year. At 27 million bales, however, these stocks will still be 15 percent above the average of recent years.

In the most general sense, policy implications are clear: The U. S. cotton industry must sell very aggressively in both domestic and foreign markets, continue adjusting supply levels according to the fundamental realities of world demand, and maintain the infrastructure upon which the long-term viability of the industry depends. But the details of balancing and

implementing these general policy objectives will raise agonizing questions regarding equity and efficiency throughout the agricultural economy. The wisdom and resolve of participants in every segment of the raw cotton industry will be severely tested throughout the coming year.

ECONOMIC ENVIRONMENT

UNITED STATES

Economic developments throughout 1982 were dominated by the stubborn recession which began in mid-1981. At the end of 1981, most analysts expected weakness during the first half of 1982, but a fairly strong recovery for the second half. Unfortunately, stagnation characterized business activity all year long, making 1982 the fourth consecutive year of little or no real economic growth.

The year began with a sharp decline in total output, as inflation-adjusted Gross National Product dropped at a 5.1 percent annual rate in the first quarter (Exhibit 1). During the second period, GNP increased at a 2.1 percent rate. The recovery did not materialize, however. Economic activity advanced less than 1 percent in the third quarter and declined 2.5 percent in the fourth.

The protracted business slump resulted principally from record high interest rates--due to the combination of a restrictive monetary policy, a large tax cut, and failure to reduce government spending significantly. Although interest rates declined significantly from 1981 levels, real interest rates (nominal rates less inflation) stayed near historical peaks. Thus, the prime lending rate decreased from 16.5 percent in June to 11.5 percent by December, but the inflation rate fell from 8.9 percent in 1981, to less than 4 percent in the latter part of 1982 (Exhibit 2). This represented a definite

improvement, but it still left the difference between inflation and interest rates at stifling levels.

Demand for durable goods was hurt most by this scenario. Consequently, industrial production declined steadily throughout most of 1982, falling nearly 12 percent since the beginning of the slump in July 1981 (Exhibit 3). The production drops were broad-based but particularly affected the nation's basic industries, such as construction, steel, autos and rubber. Moveover, capacity utilization of the nation's factories fell to the lowest levels on record.

Due to production cutbacks and plant closings, the unemployment rate soared to the highest level since 1941 (Exhibit 4). Of course this depressed income growth and eroded consumer confidence, both of which are major influences on consumer spending--which in turn accounts for almost two-thirds of total GNP. Inflation-adjusted retail sales declined for the fourth year in a row (Exhibit 5).

Some very encouraging economic signs in late 1982 included increased housing starts, a rising stock market, lower international exchange rates for the dollar, growing consumer confidence, and a sustained uptrend in the index of leading economic indicators. All of these are just "symptoms" of an economy that may be capable of improvement in the months ahead. There are, however, at least four <u>fundamental factors</u> underlying these symptoms that offer a more solid basis for anticipating economic recovery:

(1) <u>Inflation</u> -- Not only is inflation down; it also appears to be on a declining trend. The beneficial effects of this are literally too numerous to summarize. Among them are the fact that saving once again becomes a virtue rather than stupidity. Speculation in everything from stamps to gold to real estate is no longer made "clever" by continually rising price levels.

Managers and employees alike are better able to perceive the fact that profits, wages, salaries, and fringe benefits are ultimately dependent upon their business' success at providing goods and services.

(2) Productivity -- Contributing to the deceleration of inflation is growth in productivity. After declining in 1979 and 1980, output per worker hour increased 1.8 percent in 1981 and 0.2 percent in 1982. It is expected to advance about 2 percent in 1983. Such growth is necessary for stable economic improvement.

(3) Interest Rates -- Also necessary is lower real interest rates, which finally fell significantly in the last part of 1982 (Exhibit 2) and which appear unlikely to escalate again before late 1983. This may give the Federal government time to find the wisdom and courage to instigate policies that will help interest rates toward a long-term downtrend.

(4) Disposable Income -- Consumer real disposable income increased about 1 percent during 1982 and is expected to grow about 4 percent during 1983. Even allowing for a higher savings rate (which is also good for long-term growth), this will enable a return to spending on items that have been postponed during the recession.

Of the factors which seriously threaten to subvert a sustained economic recovery, two appear to be paramount:

(1) Budget Deficits -- Unless a meaningful beginning is made in 1983 to bring federal budget deficits under control, they threaten to absorb the resources for private investment and productivity growth just as surely as inflation has done in past years. Furthermore, if the massive treasury borrowing continues as the economy recovers, interest rates will inexorably rise again -- and the Federal reserve board will not be able to use monetary policy to help lower them without rekindling inflation.

(2) Structural Unemployment -- While any unemployment is serious, the more persistent type is structural unemployment ralated to inefficiency and excess capacity in manufacturing and durable goods segments of the U. S. economy. The necessary growth in productivity and elimination of excess capacity practically assures that unemployment will remain high during the months and years ahead. Significant reductions in unemployment will depend primarily on adaptability of the work force to changing job opportunities. If political pressures force uncompetitive wages and work rules on U. S. industries, the only way to prevent them from failing will be through overt trade restrictions and other protectionist measures. Yet these "solutions" would almost certainly lead to the collapse of international commerce, a return to spiraling inflation, and eventually to worldwide depression.

The prospects for success of the Reagan administration's economic recovery program have always been dependent on four basic components: tax reform, budget restraint, monetary restraint, and regulatory reform. These components are highly interrelated, so that failure to achieve any one of them will inevitably force alterations in the others. Clearly the limiting component going into 1983 is the size of the Federal budget deficit. Unless substantive (rather than cosmetic) reductions are made in the growth potential of the major federal budget components during 1983, it is easy to predict that wholesale changes in the economic program will eventually be required.

WORLD

The 1981-82 recession was worldwide in scope, impacting most other nations at least as much as the U. S. The high U. S. interest rates helped keep international exchange rates for the dollar very high. This not only reduced other countries' purchasing power for U. S. goods and services, but for all

other international goods and services requiring payment in dollars. High global interest rates combined with escalating debt loads in many developing countries to cause widespread concern about a global financial crisis.

The volume of world trade suffered, falling about 2 percent in 1982 after rising 0.5 percent the year before. Owing to high dollar exchange rates and lagging recoveries in foreign economies, U. S. exports of all goods and services lost ground to imports throughout 1981 and 1982. For the first tiem since mid-1978, U. S. exports of goods and services fell below imports in the fourth quarter of 1982, for the first time since mid-1978.

Real growth in the major industrial nations as a group averaged slightly less than 1 percent last year. Japan led the developed countries with only a 2 percent rise in total output (Exhibit 6). Both Britain and France recorded advances of less than 1 percent, while West Germany and Canada sustained declines.

Economic growth rates were slightly higher in the developing nations, increasing an average of 1.6 percent. In several Far East countries that are major buyers of U. S. cotton, growth rates in 1982 generally fell below 1981 levels (Exhibit 7), due in large measure to declining exports. Nevertheless, the growth rates in these countries were higher than the average for developing nations in 1982.

The prevailing consensus is that most foreign economies will lag improvements in the U. S. economy up to several months. Therefore, the economies of our trading partners will likely be weaker in 1983 than will the U. S. economy. To the extent that dollar exchange rates continue to moderate, their export potential will be dampened in the short term, but expanding economic activity in the U. S. would offset this eventually by presenting them a larger total market.

DOMESTIC SUPPLY

1982-83 CROP

The combination of depressed 1981 cotton prices, weak fiber demand, and the likelihood of relatively high carryover stocks convinced USDA to announce an acreage reduction program for cotton in late January, 1982. Program participation required a 15 percent cutback in plantings from the base acreage and early intention surveys showed producers willing to reduce acreage this much and more, due in large part to cotton's market price being less than competitive with major competing crops during early 1982.

Acreage and Production

Cotton producers actually planted 11.5 million acres last spring, a 19.5 percent reduction from 1981-82 and 25 percent below the national base acreage for cotton. Severe weather in late June devastated the Texas Plains, causing USDA estimates of Beltwide production to drop as low as 10 million bales. However, yields turned out slightly above average in the West and near-ideal weather conditions in the Mid-South and Southeast resulted in all-time record yields for nine states in these regions (Alabama, Arkansas, Florida, Georgia, Mississippi, North Carolina, South Carolina, Tennessee, and Virginia). The net result was the largest Beltwide yield per harvested acre on record and a Beltwide crop of slightly over 12 million bales.

Production Expenses

Although production input costs increased again in 1982-83, the rate was the lowest in recent years. According to USDA surveys, prices of production items such as seed, chemicals, and materials rose less than 1 percent in 1982 following a jump of over 7 percent in the prior year. Average agricultural fuel prices actually fell 3.4 percent last year, though heavy users of natural gas did not benefit. Fertilizer expense increased only 0.5 percent. Wage rates, which rose at an annual rate of about 8 percent between 1972-1981,

climbed 3.6 percent during 1982. Prices of tractors and machinery rose 8.5 percent, following increases of more than 11 percent in each of the past three years (Exhibit 8).

Aside from this moderation in input costs, the exceptional yields in the Southeast and the Mid-South helped to hold down costs on a per pound basis.

Cotton Prices

During the first four months of 1982, prices received by farmers averaged under 50 cents per pound, but managed a modest uptrend for the remainder of the year (Exhibit 9). A peak of near 58 cents was reached in July, as a result of supply uncertainty caused by June storms in the Texas Plains. The price dropped back to around 55 cents in August and September, after it became apparent that the cotton supply would still be adequate. Then it rose to near 60 cents in October and November, finishing the year at about 59 cents -- 21 percent above the February price level.

The market was so weak throughout 1982 that farmers had to depend on the government loan to provide a rising "floor" for producer prices. The straight line in Exhibit 9 provides an approximation of the price required in each month to bring cotton out of the loan. It is derived by adding monthly carrying costs (e.g., receiving, storage, and interest) to the loan value of the cotton. Unless the producer received payment for the loan value plus accrued carrying charges, he is better off to not redeem his cotton. Buyers of loan cotton typically made "equity bids", offering a small premium over carrying expenses, to give farmers incentive to sell.

By March, 1982, over 5 million bales were in the loan. By May, the average producer price had risen above the loan floor. It fell slightly below this floor in September, apparently due to availability of some new-crop cotton in the Delta and the Rio Grande Valley that was not eligible for the

loan. The price rose again in October and stayed above the loan floor through the end of the year.

Regional Situations

Cotton acreage and production trends in the Cotton Belt's four major production regions are determined largely by the profitability of cotton relative to alternative crops that compete for available acreage.

Southeast

Southeastern acreage planted to cotton trended down throughout much of the past decade. From a high of nearly 1.5 million acres in 1974, plantings declined to only 604,000 acres in 1978 (Exhibit 10). Then an uptrend developed, with increased cotton acreage in 1979, 1980, and 1981. In 1982, cotton acreage was a modest 9 percent below 1981 plantings, in spite of a voluntary 15 percent acreage reduction program.

In recent years cotton apparently has been considered a better alternative than major competing crops in the Southeast -- one of the most important being soybeans. After reaching a low in 1979, cotton's share of total cotton and soybean acreage in the Southeast has increased each year since. This includes the 1982 crop year, when cotton had an acreage reduction program and soybeans did not (Exhibit 11).

Between 1979 and 1981, cotton production costs rose 30 percent while soybean production costs rose 27 percent. In view of the comparable cost increases, relative prices of these commodities should be a reasonably good indicator of relative profitability.

It has been repeatedly observed that cotton's share of the combined cotton/soybean acreage tends to decrease whenever the price of cotton is less than ten percent of the bean price and increase when the ratio is greater than 10 percent. Using average prices received by farmers, the calculated

cotton-to-soybean price ratio in the Southeast was less than 10 percent in 1977, 1978, and 1979. The ratio was over 10 percent in 1980 and 1981, but fell marginally below this level in 1982 (Exhibit 11).

Of course the price picture is incomplete until target price deficiency payments are added to cotton's market prices. These payments raise the price ratio to almost 11 percent for both the 1981 and 1982 crops (Exhibit 11).

The conclusion is that total cotton receipts, including deficiency payments, have been adequate to cause increased cotton plantings. Furthermore, unless circumstances change significantly, the target price level in 1983 is expected to keep cotton revenue in a favorable position relative to soybeans. Therefore, in the absence of governmental acreage reduction provisions, Southeast producers would be expected to further expand cotton acreage.

Mid-South

Cotton acreage trends in the Mid-South have been similar to those in the Southeast. Cotton plantings declined to just under 2.6 million acres in 1979, increased in 1980 and 1981, then fell back to just over 2.6 million acres in 1982 (Exhibit 12).

Soybeans are also one of the major competing crops in the Mid-South and the 10 percent cotton/soybean price ratio is a rule-of-thumb breakeven point above which cotton acreage will tend to increase. However, cotton's share of total cotton and soybean acreage declined modestly in 1982, in spite of a price ratio above 10 percent (Exhibit 13).

Between 1979 and 1981, cotton production costs in the Mid-South increased about 28 percent, while soybean costs increased 31 percent. But even though relative cost increases have been comparable, the combination of cotton's high per-acre variable costs and the extent of double-cropping soybeans with wheat

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in the Mid-South probably prevented some additional cotton acreage in 1982. Based on USDA data, per-acre variable costs for a double-crop of soybeans and wheat are less than those for cotton alone. This situation made production financing for cotton more difficult in 1982, when interest rates were at historical highs. Therefore, even some farmers who felt that cotton offered the prospect of a better net return may have chosen soybeans and/or wheat.

The acreage reduction program for cotton was no doubt an additional factor in the shift from cotton to soybeans, but its net impact is difficult to assess.

It appears that (a) net returns from cotton compared very favorably to most alternative crops in 1982, (b) reduced interest costs will make production financing easier in 1983, and (c) target price deficiency payments are expected to keep the cotton/soybean price ratio above 10 percent (Exhibit 13). Therefore, it is expected that Mid-South producers will include cotton in their cropping plans to the maximum extent allowed by government programs.

Southwest

Relatively low production costs help explain the increasing trend in Southwest cotton acreage over the past ten seasons. A peak of 7.9 million acres was reached in 1980 (Exhibit 14).

Grain sorghum is cotton's primary competitor for available acreage in the Southwest. Cotton's share of total cotton and sorghum planted acreage rose from 53 percent in 1977-78 to 61% in 1980-81. It dipped slightly to 60 percent in 1981-82, but then dropped substantially to 50% in 1982-83 (Exhibit 15).

An examination of cotton's share of total cotton and grain sorghum acreage over the past decadae suggests that a cotton/sorghum price ratio above 12.5

percent makes cotton preferrable to grain sorghum. Conversely, a price ratio below 12.5 percent causes cotton's share of acreage to fall (Exhibit 15). While adjustment of the price ratio for 1982 deficiency payments made the ratio favor cotton, it is thought that most producers did not anticipate the impact of these payments at planting time in 1982.

At least two additional factors can be identified as contributing to the 1982 drop in cotton's share of acreage in the Southwest. One is the high production cost of cotton relative to grain sorghum and the accompanying production financing problems. The other is high participation rates in the 1982 cotton acreage reduction program. Southwest cotton farmers had a 92 percent participation rate, highest of all regions. Although sorghum also had an acreage reduction program (of 10 percent), only about 35 percent of the acres were in compliance.

Given the importance of both the Commodity Credit Corporation loan program and the target price deficiency payment to the Southwestern cotton producers, most will continue to protect their eligibility for these with requisite acreage reductions -- subject to constraints imposed by payment limitations. However, the comparative advantage of cotton relative to major competing crops is great in the Plains areas of this region. Therefore, the existing base acreage is expected to remain available to grow cotton whenever government programs (and market conditions) permit.

West

Cost per pound of cotton production is relatively low in most of the West region, due in large measure to consistently high per-acre yields. Total cotton acreage exceeded two million acres in 1977 and remained above this level until last year (Exhibit 16).

While diverse specialty crops compete for cotton acreage, their impacts are not great in any given year. Wheat and barley are capable of displacing substantial cotton acreage, but strong price/acreage responses have not been apparent.

The size distribution of cotton farms, along with generally high yields, in much of the Western region makes a $50,000 government payment limitation a serious constraint on compliance with acreage reduction programs. This largely explains the fact that only 49 percent planted acres in the West participated in the 1982 acreage reduction program. With the payment limitation removed under the PIK program, it is expected that Western producers will generally respond to incentives in acreage reduction programs.

ACREAGE EXPECTATIONS FOR 1983-84

Despite prospects for cotton prices well below production costs for most growers as spring 1983 approaches, cotton's cost/return outlook is relatively better than most alternative crops. Past experience would suggest an increase in cotton acreage under these conditions.

Less than one month ago the federal government announced the Payment-In-Kind program to encourage growers to reduce their 1983 plantings of cotton and other crops beyond the levels required by the reduction and diversion programs. In return for decreasing acreage, a producer participating in PIK would receive as payment a quantity of the commodity which was not planted.

Effects of Government Programs

Introduction of the payment-in-kind (PIK) program by USDA adds to the complexity of reaching cost/return conclusions for the 1983 crop. Major decision variables can be clarified with some illustrative examples. Three

major simplifying assumptions are made: (1) the farm's program yield and its actual yield are the same. (2) The value of both the PIK and the new-crop cotton is 55 cents per pound (the same as the loan value for base grade cotton). (3) Ginning cost is approximately offset by seed revenue (so these are excluded from the calculations). Additionally, only variable costs are used in comparing alternatives, since practically all fixed costs are incurred regardless of the alternative chosen.

Before giving the examples, it should be noted that two advantageous provisions of the acreage reduction programs are not illustrated by them. One is that program yields will generally be higher than expected average yields, especially in areas where weather-relatead yield variations are common. This tendency will result in deficiency and PIK payments at somewhat higher effective rates than stipulated in the programs. Additionally, PIK participants have been given 6 to 10 percent increases in yield guarantees under federal crop insurance, but with no additional premium cost. This further reduces yield-related risk that the farmer has to bear.

Example I on the next page assumes a 500-acre cotton base with a program yield of 500 lbs. per acre. Column A shows results for a "non-complier." In this case the entire 500-acre cotton base is planted to cotton and sold at a 55-cent market value. (Although not considered here, the non-complier also has the option of planting more than his base acreage.) This grower would receive $137,500 for his cotton. Using USDA's variable cost data (Beltwide average) he could expect to incur variable costs totaling $108,300. The result is a net over variable costs of $29,200.

Column B of Example I shows results of complying with the 20 percent acreage reduction program. A maximum of 400 acres can be planted, resulting in new-crop cotton revenue of $110,000. Under the assumption that the

Example I

Base acreage = 500 acres
Actual yield = Program Yield = 500 pounds/acre
Market price = PIK value = Loan level = 55 cents/pound

	COTTON PROGRAM ALTERNATIVES		
	(A)	(B)	(C)
	Non-Complier	20% Complier	20% + 30% Complier
Planted Acreage	500	400	250
Market Revenue	$137,500	$110,000	$68,750
Deficiency Payment 1/	--	$42,000	$26,250
PIK Payment	--	--	$33,000
Revneue Potential	$137,000	$152,000	$128,000
Variable Cost 2/	$108,300	$86,640	$54,150
Conservation Cost 3/	--	$2,500	$6,250
Net Over Variable Costs	$29,200	$63,860	$67,600

1/ Assumes deficiency payment = 21 cents/pound
2/ Cost/acre = (USDA Beltwide estimate) - (ginning charges)
= $266.91 - $50.31 = $216.60
3/ Cost/acre = $25.00

Beltwide average price received by farmers is 55 cents per pound, a deficiency payment of 21 cents per pound adds another $42,000 in revenue. The result is arevenue potential of $152,000. Variable costs on 400 planted acres are $86,640. The 100 acres withdrawn from cotton production must be put into conserving uses, so related conservation costs must also be included. These vary greatly by regions, but a "representative" cost of $25 per acre, or $2,500 total, is used here. The resulting net over variable and conservation costs is $62,860.

Column C of Example I shows results of compliance with the acreage program plus the maximum 30 percent compliance in the PIK program. A total of 250 acres are withdrawn from production and 250 acres are planted in cotton. The same yield and price assumptions would result in market revenue totaling

$68,750. A 21-cent deficiency payment would add $26,250. Additionally, PIK's are received on 80 percent of program yield from 150 acres. At 55 cents per pound, this results in $33,000. Total revenue potential, therefore, is $128,000. Variable cost on 250 acres is $73,830 and conservation cost on 250 acres is $6,250. Subtracting these leaves a net over variable and conservation costs of $67,600.

The basic decision process is even more complex for a larger grower. Example II assumes a 5,000 acre base and a 1,000-pound per acre yield. Market and PIK values are the same as in Example I but variable costs are higher. USDA's variable cost for the West is used under the assumption that it is somewhat more typical for a 1,000-pound yield. The non-complier (column A) in this example received $367,900 net over variable costs.

Assuming exact compliance with the 20 percnet acreage reduction program, 4,000 acres are planted to cotton (Example II, column B). Adding the deficiency payment, which is limited to $50,000, makes the revenue potential from cotton $2,250,000. However, the grower may reduce conservation acres proportional to the amount that the $50,000 limit reduces what would otherwise be received in deficiency payments. Accordingly, only 62.5 acres are put into conserving uses and the balance of th 1,000 acres withdrawn from cotton production (i.e., 937.5 acres) can be planted to another crop. Variable costs on 4,000 acres are $1,905,680 and conservation costs on 62.5 acres are $1,563. The resulting net over variable cost of 342,757. However, it must be remembered that this excludes any net revenue realized from other crops planted on the remaining 937.5 acres.

Column C of Example II gives results for the 20 percent plus 30 percent complier. In this case only 2,500 acres are planted to cotton, giving a market revenue of $1,375,000. Again, the deficiency payment is limited to

Example II

Base acreage = 5,000 acres
Actual yield = Program Yield = 1,000 pounds/acre
Market price = PIK value = Loan level = 55 cents/pound

	COTTON PROGRAM ALTERNATIVES		
	(A)	(B)	(C)
	Non-Complier	20% Complier	20% + 30% Complier
Planted Acreage	5,000	4,000	2,500
Market Revenue	$2,750,000	$2,200,000	$1,375,000
Deficiency Payment 1/	--	$50,000	$50,000
PIK Payment -- 80%	--	--	$660,000
-- 50%	--	4/	$257,813
Revenue Potential	$2,750,000	$2,250,000 4/	$2,342,813
Variable Cost 2/	$2,382,100	$1,905,680	$1,191,050
Conservation Cost 3/	--	$1,563	$62,500
Net Over Variable Costs	$367,900	$342,757 4/	$1,089,263

1/ Assumes deficiency payment = 21 cents/pound
2/ Cost/acre = (USDA estimate for West) - (ginning charges)
= $586.59 - $110.17 = $476.42
3/ Cost/acre = $25.00
4/ Since 937.5 of the acres removed from cotton may be planted with other commercial crops, these figures understate the revenue potential.

$50,000. The PIK's on 80 percent of yield from 1,500 acres generates another $660,000 in revenue. Additionally, the producer now has the option to receive PIK's on the 937.5 acres which he otherwise would be eligible to plant to other crops. However, PIK's on these 937.5 acres are based on only 50 percent of his program yield. Choosing this option results in additional PIK's of $257,813, making the total revenue potential equal $2,342,813. Subtracting variable cost and conservation cost leaves net over variable costs of $1,089,263.

In both examples presented, participation in the PIK program results in largest net revenue. Of course results could have been different with different assumptions. Obviously the farmer cannot predict with certainty the price of new-crop cotton, the level of deficiency payments, or the value of

PIK payments. In addition to reaching acceptable assumptions about these revenue components, each decision-maker will have to select cost figures most appropriate to his situation. Nevertheless, to the extent that these examples are fairly representative of most situations, they make a strong case for expecting widespread participation in the PIK program.

January Planting Intentions Survey

(Due to timing of the survey, results could not be included in this preliminary draft. It will be included in the final published version of The Economic Outlook for Cotton.)

DOMESTIC MARKET

Domestic demand for textiles during 1982 was at its lowest level since the recession of 1975. Total domestic fiber consumption is estimated at 23 million 480-lb. bale equivalents, only 0.8 million above the depressed 1975 level and 3.8 million below the 1978 peak of 26.8 million bale equivalents (Exhibit 17).

Monthly operating rates for textile mills fell from a high point of 84.2 percent in the third quarter of 1981 to an estimated 74.3 percent in the fourth quarter of 1982 (Exhibit 18). However, the operating rates for textiles were consistently better than the average of all U. S. manufacturers and better still than the rate for chemical manufacturers (which include man-made fiber manufacturers).

The three major textile end-use categories are apparel, home furnishings, and industrial uses. Apparel consumption generally suffers least in recessionary times; therefore, it is not surprising that National Cotton Council data on domestic textile manufacturers indicate that apparel outpout

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benefits U. S. cotton, because about 58 percent of its domestic utilization is in apparel textiles -- versus about 30 percent in home furnishings and 12 in the various industrial uses (Exhibit 20). Since almost all the remaining fibers used are man-made, the relative output changes among end-use categories have helped cotton more than man-made fibers during the recession.

Since textiles for home furnishings and industrial uses suffred relatively more from the recession, they are expected to benefit relatively more from a recovery. Of course this will likely make man-made fiber consumption improve faster than cotton consumption -- causing a drop in cotton's market share of total fiber consumption. Such a "mechanical" decrease in market share is not of great concern to the cotton industry. The challenge, rather, is to maintain or increase market share within each major end-use category, so that cotton will benefit proportionately to improvements within each one.

The two strategic demand levels in the textile marketing system are textile mills and retail consumers; therefore, understanding the dynamics of cotton consumption trends requires knowledge of both levels.

TEXTILE MILL DEMAND

Cotton utilization by domestic mills has been dismally low since the fourth quarter of 1981, generally staying below an annual rate of 5.3 million bales until the fourth quarter of 1982 (Exhibit 21). The result was mill consumption during calendar 1982 of only 5.3 million bales, the lowest annual volume since 1934.

It should be emphasized that this low cotton use by domestic mills has not been caused by losses in market share to competing fibers. In fact, cotton's market share has held up well since the fourth quarter of 1981. Furthermore, on an annual average basis, cotton's share of U. S. mill has held up best during the past two years (Exhibit 19). This certainly

consumption has risen from 23.9 percent during 1981 to 24.9 percent during 1982 (Exhibit 22). While mill usage of cotton has declined in an absolute sense during the recession, it has increased somewhat relative to competing fibers.

CONSUMER DEMAND

U. S. consumers are continuing to reveal a preference for more cotton in many of their textile products. While it is difficult to estimate total end-use purchases of cotton textiles, a reasonably good approximation is the "net domestic consumption" of cotton. This is the sum of domestic textile mill use of cotton and net cotton textile imports (= cotton textile imports - cotton textile exports). It will generally equal retail consumption except for inventory changes.

As shown in Exhibit 21, net domestic consumption of cotton in the last half of 1982 had recovered to the levels of the first half of 1981. By expressing net domestic cotton consumption as a percentage of total net domestic consumption of all fibers, an estimate of cotton's aggregate market share is obtained. This market share has increased from an average of 27.1 percent in 1981 to 28.5 percent in 1982 (Exhibit 23). To put this in perspective, each 1 percent increase in this market share results in increased cotton consumption of about 250,000 bales.

CURRENT DEMAND ISSUES

The consumption of cotton in relation to other fibers has been discussed in the general framework of recessionary demand levels and consumer preferences. Of course many other factors may significantly alter demand levels and trends. Factors that qualify as current demand issues include price competition, interest rates, textile trade deficits, and cotton dust

regulations. It is noteworthy that the continuing resolution of these issues will occur primarily at the textile mill level, rather than at the consumer level.

Price Competition

An obvious reason for cotton's improving share of mill consumption in recent months is very competitive prices relative to man-made fibers. The average mill delivered price of SLM 1-1/16" cotton went from about 8 cents above reported polyester staple fiber prices in the first quarter of 1981, to about 19 cents below by the last quarter of that year (Exhibit 24). Throughout 1982, the cotton price was generally 6 to 14 cents below reported polyester prices. Even with allowances for additional discounting from reported man-made fiber prices, cotton has been quite competitive on the basis of price.

Domestic mills have been predictably slow in responding to these price incentives, for at least two reasons: First, they have become accustomed to large short-term movements in cotton prices. This variability generally frustrates their production planning and adds to their cost of using cotton as a raw material. Second, related to this is the fact that mills which have made a commitment to man-made fibers are not easily persuaded to significantly alter prevailing blend levels. Such alterations are too expensive and difficult to undertake for what may be a temporary price advantage. However, as these price incentives have persisted for several months -- reinforced by a demonstrable consumer preference for more cotton in their apparel -- more mills have begun to use higher percentages of cotton in their fabric blends.

Interest Rates

Both the average level and the variability of interest rates during the last two years have been very detrimental to cotton offtake by domestic mills.

Large fluctuations in interest rates have effects similar to the aforementioned price fluctuations, while generally high rates have consistently worked to offset incentives provided by low cotton prices. Moreover, prohibitive carrying costs on inventories have kept stocks owned by both merchants and mills at historically low levels. For example, a 20 percent interest rate makes 68-cent cotton cost 75 cents after six months in inventory. At no time during 1982 did buyers become convinced that the risk of cotton price increases outweighed the known carrying costs.

In contrast to cotton, man-made fibers are produced every day of the year and can be shipped to mills as needed. Therefore, little inventory is required and the interest on inventory is relatively insignificant. To some extent, fiber manufacturers' costs of inventory management are reflected in average prices charged for man-made fibers. Textile mills must balance these prices against cotton prices plus the additional expense involved with holding sufficient cotton to meet production targets.

Textile Trade Deficits

Rapidly worsening textile trade deficits became a major issue in 1981. Unfortunately, the situation became even more serious during 1982, with the total textile trade deficit reaching an annual rate of almost 2.8 million bale equivalents in the third quarter (Exhibit 25). This was the worst quarterly deficit ever recorded and, if it persisted, would result in about 17 percent of total U. S. textile consumption coming from other countries.

The impact on cotton textiles can be seen by referring back to Exhibit 21, where it is clearly shown that, while net domestic consumption of cotton textiles has held up pretty well, imports of cotton textiles have taken larger chunks of the market at the expense of domestic mills. This must concern U. S. cotton farmers also, because domestic mills use practically 100 percent

domestic cotton, but the majority of cotton textile imports are made from foreign-grown cottons.

While cotton textiles have suffered chronic trade deficits for many years, man-made fiber textiles have generally varied between modest deficits and modest surpluses. This changed dramatically in 1982, however, as the deficit in man-made fiber textiles plunged to an annual rate of over 900,000 bale equivalents by the third quarter of 1982. This made the trade deficit for man-made fiber textiles over half as large as the 1.6 million-bale deficit for cotton textiles (Exhibit 25). It appears that foreign textile competition may now stand ready to challenge the domestic industry in man-made fiber fabrications just as it has done with cotton fabrications for many years.

Ironically, increased textile imports have probably encouraged the domestic textile industry to speed up its recent emphasis on high-cotton blends. This is because the foreign mills are more likely to use all-cotton or high-cotton blend yarns to make their fabrics and apparel; therefore, their products have given U. S. consumers a better opportunity to make their preference for cotton known in the marketplace.

Cotton Dust

An overriding reason why foreign textile mills are more inclined to utilize cotton is that they are not burdened with the cotton dust regulations imposed on U. S. mills. Indeed, during a transition period, many domestic mills concluded that they had no choice but to utilize less cotton in order to meet existing cotton dust standards.

Although the domestic industry has spent hundreds of millions of dollars on engineering controls, meeting these cotton dust standards still limits the amount of cotton that some mills can utilize. In these times of high interest

and scarce capital investment funds, it is no wonder that U. S. mills require strong evidence of cotton's value in the marketplace.

EXPORT MARKETS

Despite abundant supplies of U. S. cotton, exports are projected to decline substantially in 1982-83. This is due to a combination of factors, including: the worldwide recession that has stiffled growth in fiber consumption, large world stocks augmented by a second consecutive large crop, lower import demand by the major net importers of raw cotton, and a strong dollar that has made U. S. cotton more expensive in the world market than most other growths.

WORLD TEXTILE SITUATION

All Fibers

World consumption of all fibers has not shown any significant growth over the last three years (Exhibit 26). In fact, it is estimated to have declined slightly in 1982.

During the past decade, there have been two major worldwide recessions: one from 1973 to 1975 and the current recession that is beginning its third year. World fiber consumption fell over 7 million bale equivalents during the earlier recession. The current recession has not had as severe an impact on total fiber consumption (Exhibit 26). However, per capita fiber consumption fell significantly during both recessions (Exhibit 27). In the years following the last recession, per capita consumption quickly recovered to pre-recession levels. If, as the world emerges from this recession, per capita consumption simply returns to the levels of 1978 and 1979, then world consumption would rise about 10 million bales -- as it did in 1976.

Cotton

In the case of cotton, impacts of the recessions on consumption have been less severe than for other fibers (Exhibit 28). In the 1973-75 recession, cotton consumption fell a little over 2 million bales (compared with a 4.5 million-bale drop in man-made fiber consumption). Between the two recessions, cotton consumption fluctuated but grew at at average annual rate of 1.4 million bales per year. The current recession has flattened the total consumption curve, although it has not declined. In fact, world cotton consumption is expected to set a new record this year, despite the global recession. However, as with fibers in total, impacts are more obvious on per capita cotton consumption, which dropped about a half-pound per person during both recessions (Exhibit 29).

As is the case with all fibers, a strong worldwide economic recovery could create a strong market for cotton. For example, a per capita consumption increase of a quarter of a pound would cause total cotton consumption to increase about 4 million bales.

FOREIGN COTTON SPINNING CAPACITIES

On a worldwide basis, mill spinning capacity has expanded faster than fiber consumption, creating excess spinning capacity. This helps explain why, although world consumption has not fallen substantially during this recession, individual mills around the world confront intense competition to supply existing markets.

Of course the current recession has intensified global competition, causing retrenchment of existing textile industries. The huge European textile industry reduced its spinning capacity about 1.25 million spindles

between 1974 and 1979 (Exhibit 30). This represents about a 4 percent decline in total capacity.

In the Far East, where some 80 percent of U. S. cotton exports to, recent data have revealed uneven growth (Exhibit 30). Japan and Hong Kong, for example, are in a period of transition. Both countries are reducing their overall spinning capacities, while at the same time upgrading their production to finer count yarns. Japan was the largest importer of U. S. cotton in 1982 and Hong Kong ranked sixth.

Korea and Taiwan expanded aggressively over this period and almost doubled their spinning capacities. Although growth has slowed in Korea, this country was the second largest outlet for U. S. exports in 1982 and will probably be the largest in 1983. Taiwan, last year's fourth largest buyer of our cotton, should also remain a competitive force in world textile trade.

Countries that make up the Association of Southeast Asian Nations (ASEAN), which include Thailand, Indonesia, Malaysia, Singapore, and the Philippines) have also been expanding their spinning capacities (Exhibit). As we look to the next decade, these countries will likely become significant buyers of raw fiber.

The U. S. is well positioned to compete for raw cotton exports to countries in and around east Asia. Moreover, most of these countries have very limited potential for producing their own cotton. The one major exception, of course, is China. Consistently the world's largest user of cotton, China has recently expanded its textile industry, accounting for over half the total world growth in spinning capacity during the 1974-79 period (Exhibit 30). Until last year, China was also the largest cotton importer in the world. But dramatic growth in domestic cotton production brought China to within a million bales of self-sufficiency in 1982.

Several developing countries with excess cotton production are also expanding their domestic textile industries. The four largest foreign exporters of raw cotton (Russia, Pakistan, Turkey and Egypt) have shown significant expansion in spinning capacities, particularly Russia (Exhibit 31). Impacts on U. S. exports will be mixed. To the extent that the additional textile production is exported, expansion of spinning capacity in foreign exporting countries will tend to crowd out consumption of raw cotton in the net importing countries. However, provided that increased cotton consumption by these countries does not stimulate a proportionate increase in domestic cotton production, their exportable surplus of raw cotton will be decreased. The net result may be a slower growth in world trade of cotton, but an increase in the United States' share of total exports.

WORLD COTTON SUPPLY, OFFTAKE, AND PRICE BEHAVIOR

Year-to-year fluctuations in world cotton production are occasionally quite large, such as the 10 million-bale decrease in 1975-76 and the 6 million-bale increase in 1981-82 (Exhibit 32, shaded bars). However, non-U. S. production exhibits more stability.

Adding carryover stocks to production gives the total cotton supply (Exhibit 32), which may move in different directions than production alone. Thus, world production this season is expected to decline by 3.4 million bales; however, huge carryover stocks are expected to make the world supply approach 95.4 million bales -- the largest ever.

World offtake of cotton has been in a growth trend over the past ten years (Exhibit 33). Until 1980-81, offtake averaged increasing about 1.5 percent annually. It has hardly grown at all since, but neither has it declined.

The ratio of world offtake to world supply has been a fairly good indicator of world price trends over the years (Exhibit 34). Falling consumption in 1974-75 caused a lower offtake/supply ratio and a lower price. Smaller supplies and increasing offtake in 1976-77 raised both the ratio and price. The opposite occurred in 1977-78, when a large crop combined with recessionary offtake. The offtake/supply ratio did underestimate price somewhat in 1980-81, a result of the market's reaction to the combination of large Chinese purchases of U. S. cotton in 1979-80 and the U. S. crop failure in 1980-81.

Looking towards the 1983 crop year, it appears likely that world production could decline slightly, perhaps to around 67 million bales -- assuming that U. S. acreage and yields meet USDA projections, and that foreign acreage and yields change only modestly. Carryover stocks worldwide are currently projected to be 29 million bales going into the 1983 crop year. Adding stocks to production indicates a total supply of about 96 million bales, up about half a million from the current supply.

This means that, barring significant yield reductions, consumption must improve for the offtake/supply ratio to improve much in 1983-84. A moderate economic recovery could easily increase consumption to 68 million bales (Exhibit 33). Even so, the resulting offtake/supply ratio would indicate only a modest price increase (Exhibit 34). It should be remembered, however, that relatively small percentage changes in production and/or consumption could significantly alter the ratio and price results.

WORLD COTTON TRADE

Net Importing Countries

The quantity of world trade is largely determined by the net importing countries, who have raw fiber requirements in excess of domestic production. In this sense, all net exporting countries are residual suppliers to the net importing countries. Therefore, a fundamental indicator or world trade in raw cotton is the consumption-production gap of the net importing countries.

Cotton consumption in the net importing countries has been on a consistent uptrend since the 1977-78 crop year (Exhibit 35). However, if we subtract China's consumption, the other net importing countries show a significant decline in 1981. Current estimates for the 1982-83 crop year by the Foreign Agricultural Service put consumption of cotton in these countries at 41 million bales, only about three-quarters of a million above the disappointing 1981-82 level. But, given the sluggish rate of offtake, even this could turn out to be on the high side.

As a group, the net importing countries have increased cotton production 46 percent in the last six years, going from 16.3 million bales in 1976-77 to an estimated 24.0 million bales in 1982-83. The result has been a declining consumption-production gap for the past four years (Exhibit 35). In 1982-83, this gap will likely reach the lowest point since 1974-75.

Comparing the consumption-production gap of the net importing countries to actual world imports reveals a good correlation (Exhibit 36). The tendency for world imports to exceed the consumption-production gap is due to the fact that about 15 percent of measured world imports result from re-exports and trade among the net exporting countries. USDA expects world trade this crop year to fall to about 17.5 million bales, 12 percent below last year and 24 percent below the 1979 level.

Marginal offtake improvement by net importing countries is possible in 1983-84. However, barring crop disasters in countries like China or India, aggregate cotton production will also be higher. Therefore, only a modest increase is expected in the consumption-production gap, indicating a moderate rise in total world imports, possibly to around 19 million bales (Exhibit 36).

Net Exporting Countries

Cotton production in all net exporting countries has fluctuated as much as 20 percent from year-to-year. However, except for 1975-76, production in the **foreign** exporting countries has remained virtually flat, with the U. S. accounting for most of the variation (Exhibit 37).

The primary cause of production variation -- other than weather-related yield fluctuations -- is year-to-year price changes. Certainly price has varied substantially over the past decade (Exhibit 34). High points occurred in 1973, 1976 and 1980. Low points occurred in 1974, 1977 and 1981.

As would be expected, an aggregate acreage response by the net exporting countries is evident after each of these high-price and low-price years, with acreage generally increasing after high prices and decreasing after low prices. However, closer examination indicates that **foreign** net exporting countries are much less responsive to price changes. In 1975 and 1978, following 35 percent decreases in cotton prices, foreign net exporters decreased acreage by only 4 percent. In 1982, following a 30 percent decline in world prices, their acreage fell less than 2 percent. During these three years, the U. S. accounted for about 60 percent of the acreage reductions, even though it accounts for only about one-fourth of total cotton acreage in the net exporting countries.

Although prices are still depressed, foreign net exporting countries are not expected to reduce acreage very much; therefore, any significant decrease

will again occur in the U. S. where acreage reduction provisions may result in about 8.5 million harvested acres. This would make total cotton acres in the net exporting countries decline about 1.5 million in 1983-84. If this occurs, cotton production in the net exporting countries will likely be around 43.5 million bales, or about 1.5 million below the current season.

Of course production alone does not tell how much cotton a country has to export. Adding beginning stocks and subtracting domestic consumption indicates the total cotton available for export, or the "exportable supply." The exportable supply of all net exporting countries was large in the 1981 and 1982 crop years and is expected to remain large in 1983 (Exhibit 38). The U. S. exportable supply has generally been much more stable than has U. S. production, with the U. S. share of total exportable supply tending to stay near a third. U. S. exportable supply has remained over 13 million bales since 1980 and is not expected to decline in 1983.

IMPLICATIONS FOR U. S. EXPORTS

Over the years, the U. S. share of world cotton trade has been closely associated with the U. S. share of world exportable supply. Therefore, multiplying the U. S. share of world exportable supply times total cotton trade gives a reasonably good "export indicator," as shown by comparing it with actual U. S. exports over the last 10 years (Exhibit 39). It does, however, tend to overestimate exports during years of low prices (e.g., crop years 1974, 1975, 1977 and 1981). A probable explanation is that availability of storage capacity and the cotton loan program makes it more feasible for U. S. producers to hold back cotton supplies when prices are unacceptably low. This was apparently the case in 1981-82, when about 4 million bales remained in the loan by July, 1982. If world prices make continued use of the loan

necessary, then the "export indicator" would be expected to continue overestimating U. S. exports. Certainly the USDA's 1982-83 export estimate of 5.0 million bales reveals a belief that the unadjusted export indicator is too optimistic.

A recent survey of U. S. cotton exporters indicates that exports could be even less than the USDA estimate. Most respondents expected exports to fall within a range of 4.5 to 5.0 million bales. A primary cause is thought to be the abundant Chinese crop, making U. S. export sales there almost non-existent. But export sales to other countries are also well below last year's levels. Total commitments to our 3 largest customers -- Japan, Korea, and Taiwan -- are down an average of 25 percent from the same period last year and commitments to all countries is 36 percent below last year. If sales continue at this pace, the result would be exports of only 4-1/2 million 480-pound bales.

Most exporters expect some improvement next year, but probably not to the 1981-82 level. If China maintains current production levels, imports are not expected to grow in the near term. Therefore, increased 1983-84 exports must result from generally improved textile offtake and a strong competitive U. S. position relative to the major raw cotton exporting countries.

Exhibit 1

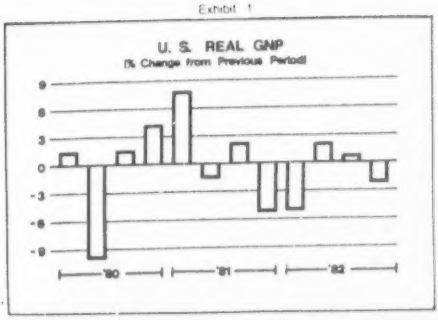
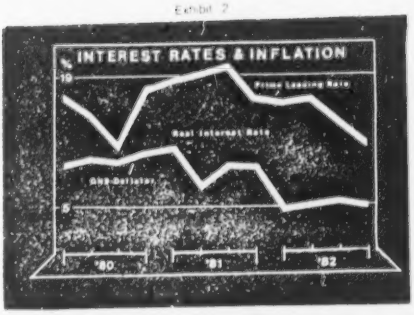


Exhibit 2



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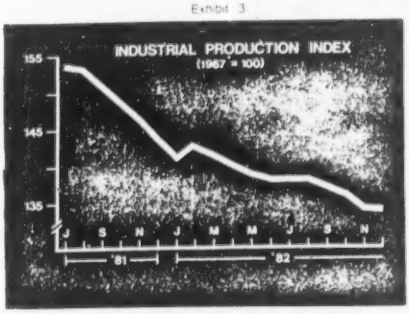

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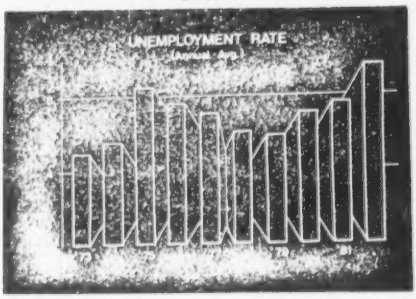

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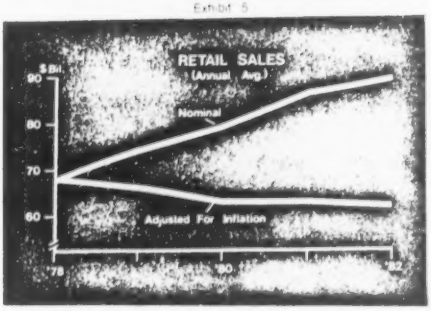

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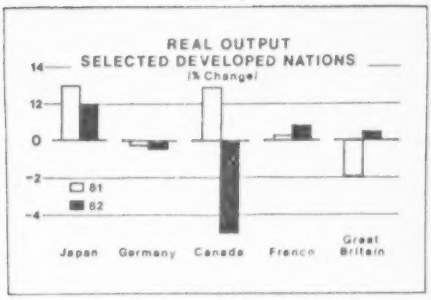

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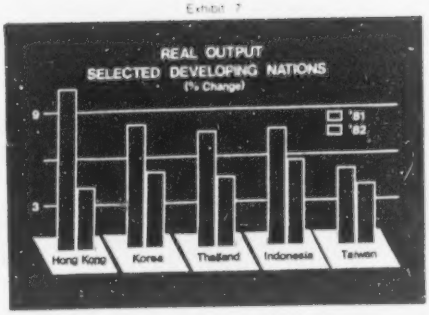

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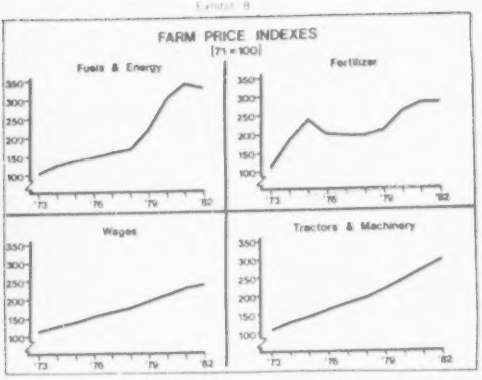

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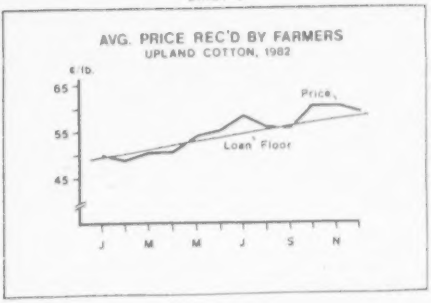

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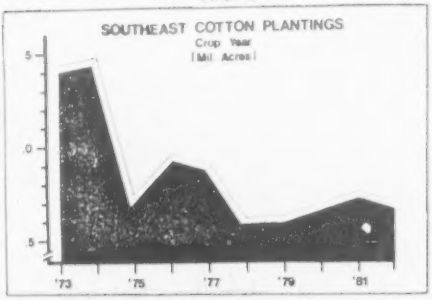

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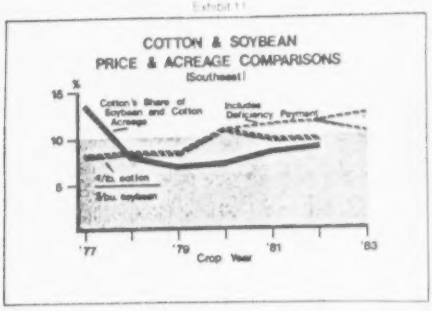

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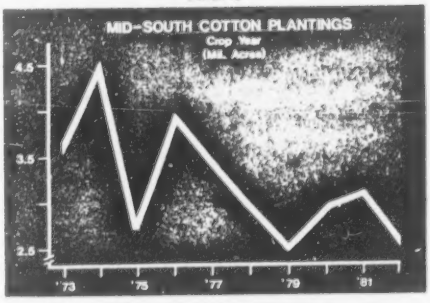

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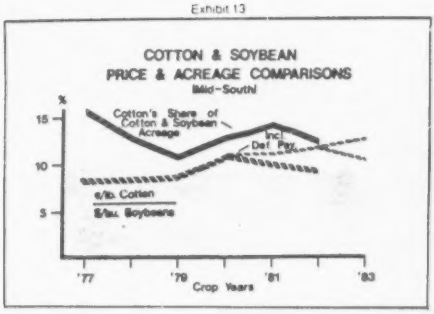

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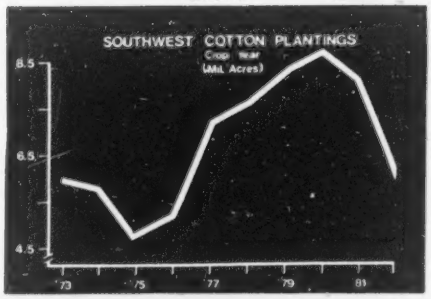

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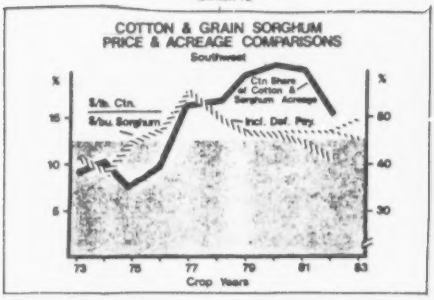

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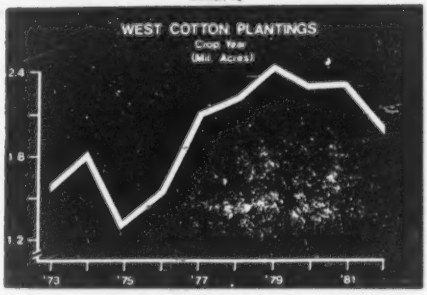


Exhibit 17

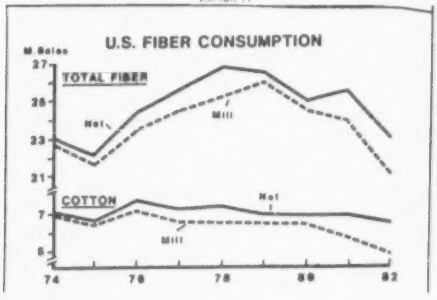
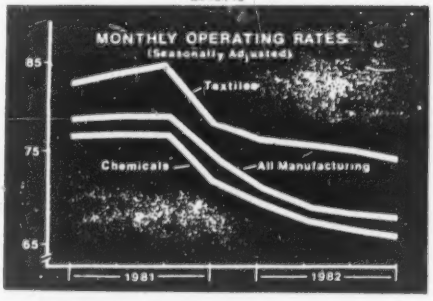
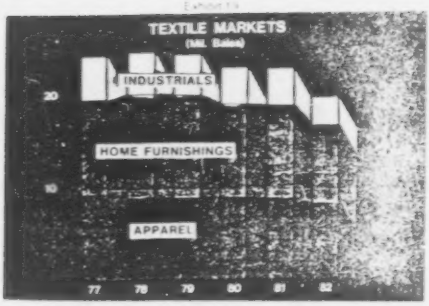
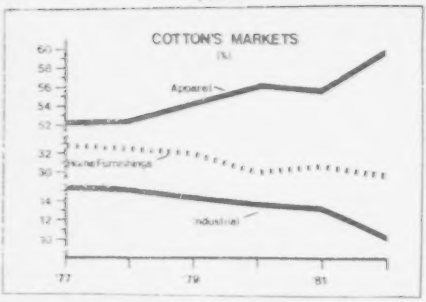
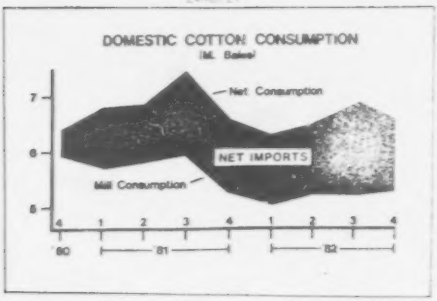


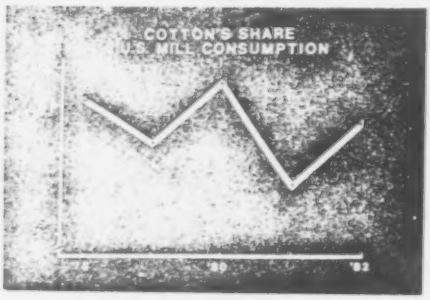
Exhibit 18

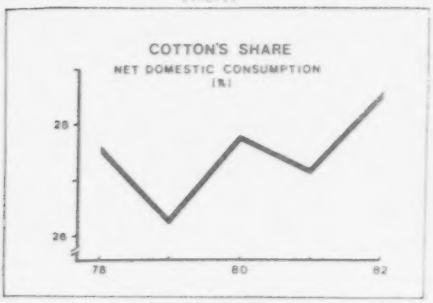


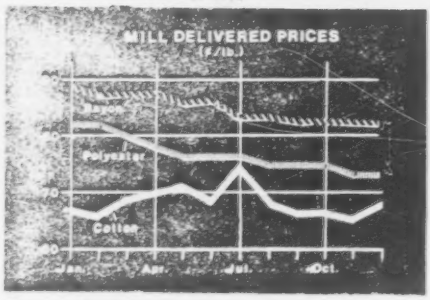

TEXTILE MARKETS
(Mil. Bales)
INDUSTRIALS
HOME FURNISHINGS
APPAREL
20
10
77
78
79
80
81
82

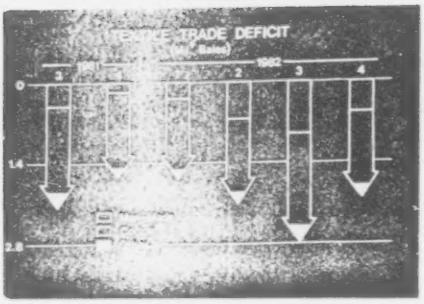

COTTON'S MARKETS
(%)
Apparel
Home Furnishings
Industrial
77
79
81

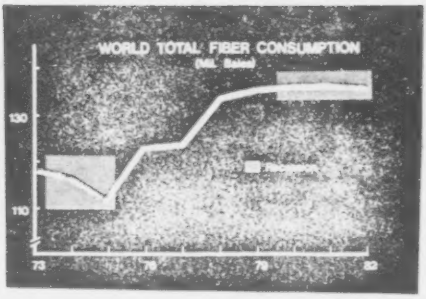

DOMESTIC COTTON CONSUMPTION
(Mil. Bales)
Net Consumption
NET IMPORTS
Mill Consumption
7
6
5
4
1
2
3
4
1
2
3
4
'80
81
82

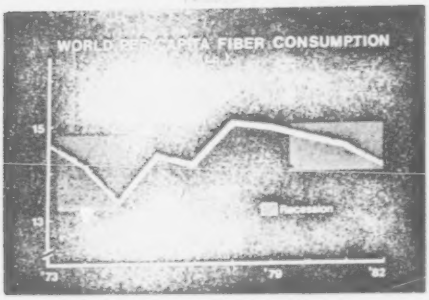

COTTON'S SHARE
U.S. MILL CONSUMPTION
'80
'82

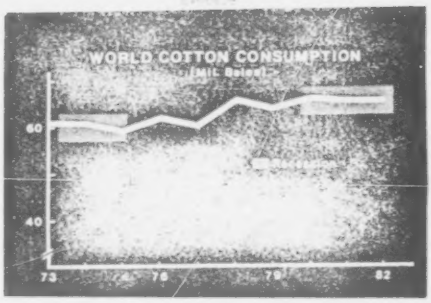

COTTON'S SHARE
NET DOMESTIC CONSUMPTION
(%)
28
26
78
80
82

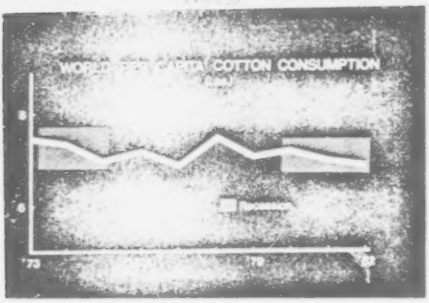

MILL DELIVERED PRICES
(¢/lb.)
Blends
Polyester
Cotton
Jan.
Apr.
Jul.
Oct.

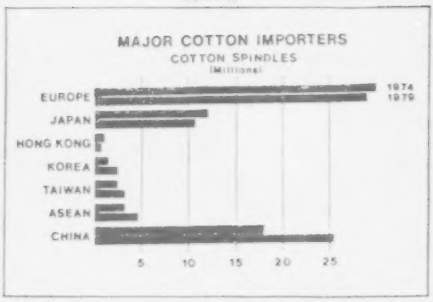

TRADE DEFICIT
1982
0
1.4
2.8
3
2
3
4

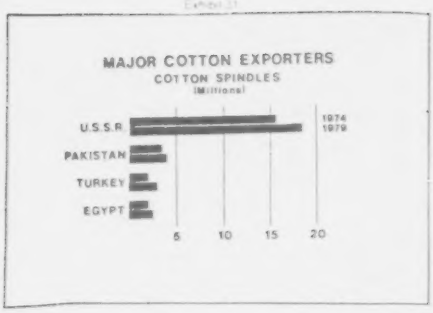

WORLD TOTAL FIBER CONSUMPTION
130
110
73
79
79
82

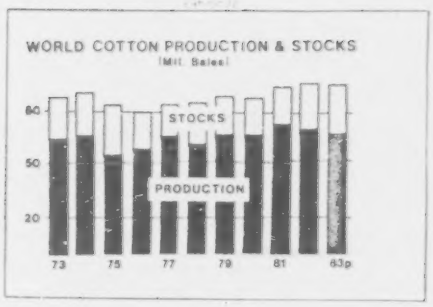

FIBER CONSUMPTION
15
13
'73
'79
'82

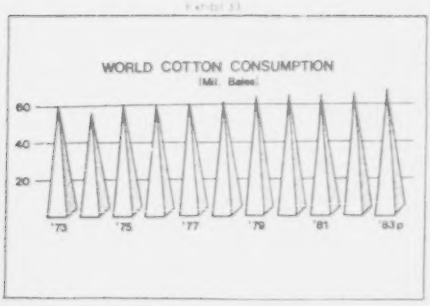

WORLD COTTON CONSUMPTION
60
40
73
79
79
82

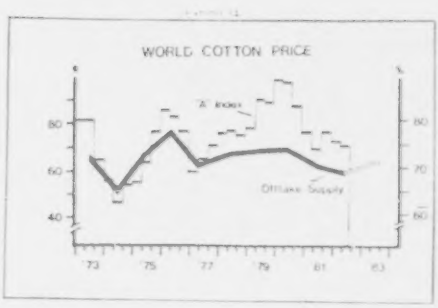

COTTON CONSUMPTION
8
6
'73
'79
'82

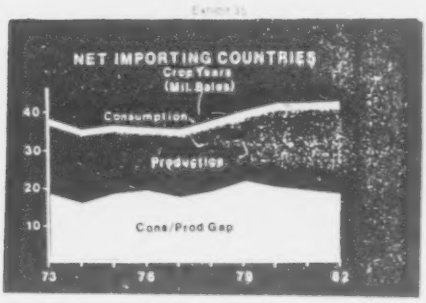

MAJOR COTTON IMPORTERS
COTTON SPINDLES
(Millions)
EUROPE
JAPAN
HONG KONG
KOREA
TAIWAN
ASEAN
CHINA
1974
1979
5
10
15
20
25

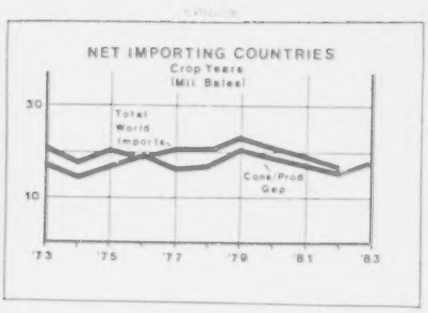

MAJOR COTTON EXPORTERS
COTTON SPINDLES
(Millions)
U.S.S.R.
PAKISTAN
TURKEY
EGYPT
1974
1979
5
10
15
20

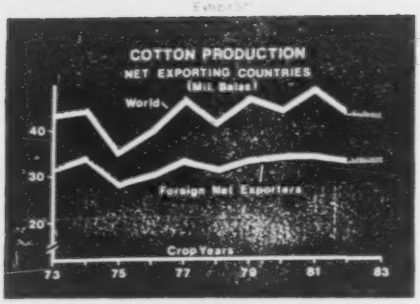

WORLD COTTON PRODUCTION & STOCKS
(Mil. Bales)
STOCKS
PRODUCTION
80
50
20
73
75
77
79
81
83p

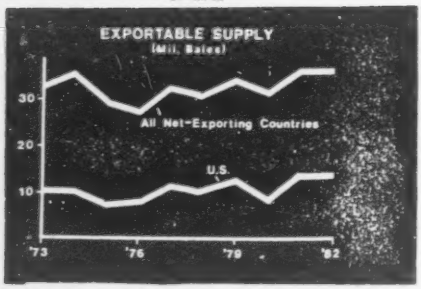

WORLD COTTON CONSUMPTION
(Mil. Bales)
60
40
20
'73
'75
'77
'79
'81
'83p

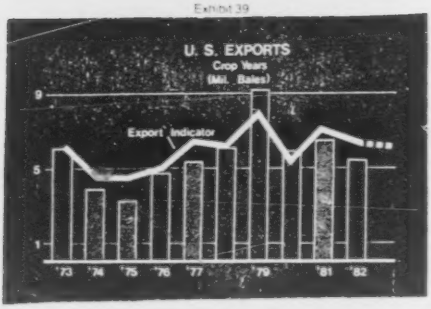

WORLD COTTON PRICE
'A' Index
Offlake Supply
80
60
40
70
'73
'75
'77
'79


NET IMPORTING COUNTRIES
Crop Years
(Mil. Bales)
Consumption
Production
Cons/Prod Gap
40
30
20
10
73
76
79
82


NET IMPORTING COUNTRIES
Crop Years
(Mil. Bales)
Total World Imports
Cons/Prod Gap
30
10
'73
'75
'77
'79
'81
'83


COTTON PRODUCTION
NET EXPORTING COUNTRIES
(Mil. Bales)
World
Foreign Net Exporters
40
30
20
Crop Years
73
75
77
79
81
83


EXPORTABLE SUPPLY
(Mil. Bales)
All Net-Exporting Countries
U.S.
30
20
10
'73
'76
'79
'82


U. S. EXPORTS
Crop Years
(Mil. Bales)
Export Indicator
9
5
1
'73
'74
'75
'76
'77
'79
'81
'82

Senator WALLOP. Thank you very much.

Ms. RICE. Thank you.

Mr. BARR. Thank you.

Senator WALLOP. The subcommittee stands adjourned. Thank you.

[Whereupon, at 3:25 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

Chuck

Dear Senator Grassley:

I enclose a copy of Treasury's bill report on H.R. 3362, a bill intended to restore tax exempt status to the National Farmers Organization (NFO) with a request that it be included in the record of Monday's joint hearing on tax legislation concerning the Administration's Payment-in-Kind (PIK) Program before the Senate Finance Subcommittees on Energy and Agricultural Taxation and Oversight of the Internal Revenue Service.

As you know, I was questioned at the hearing on Treasury's position with respect to a provision in H.R. 1296, the House version of the PIK legislation, which would exempt the NFO from tax under section 501(c)(5) of the Code. As I stated at the hearing, the Treasury Department is opposed to H.R. 3362 and the provision in H.R. 1296 relating to the tax exempt status of the NFO.

Thank you for your attention to this matter.

Sincerely,

John E. Chapoton
Assistant Secretary
(Tax Policy)

The Honorable
Charles E. Grassley
United States Senate
Washington, D.C. 20510

Enclosure

FEB 22 1983

Dear Mr. Chairman

This is in response to your request for the views and recommendations of the Treasury Department on H.R. 3362. This bill would grant tax-exempt status to agricultural and horticultural organizations operated for the purpose of bargaining collectively for the sale of members' products even though they engage in significant marketing activities.

Section 501(c)(5) of the Internal Revenue Code currently provides for the exemption from Federal income tax of labor, agricultural and horticultural organizations. The regulations state that the labor, agricultural and horticultural organizations contemplated by section 501(c)(5) are those which (1) have no net earnings inuring to the benefit of any member and (2) have as their objects the betterment of the conditions of persons engaged in labor, agriculture, or horticulture, the improvement of their products, and the development of a higher degree of occupational efficiency. (Regs. §1.501(c)(5)-1.)

Specific details as to the types of activities that tax-exempt agricultural and horticultural organizations may and may not engage in are outlined in a series of revenue rulings which emphasize that these organizations will not qualify for exemption under section 501(c)(5) if they engage in sales or marketing activities, or in any other pursuits which serve to relieve organization members of work they would either have to perform themselves or have performed for them. For example, an organization formed to carry out a livestock improvement program, whose principal activity is marketing livestock at auction as agent for its members, cannot be exempt under section 501(c)(5). (Rev. Rul. 66-105, 1966 1 C.B. 145.) Similarly, a nonprofit organization formed to manage, graze and sell its members' cattle is providing a direct business service to its members and does not qualify for exemption as an agricultural organization. (Rev. Rul. 74-195, 1974-1 C.B. 135.)

By contrast, an organization of growers and producers of a particular agricultural commodity that is formed principally to negotiate with processors for the price to be paid to members for their crops has been held exempt under

section 501(c)(5). (Rev. Rul. 76-399, 1976-2 C.B. 152.) The activities of this organization were found to be distinguishable from those of the organizations described in the earlier revenue rulings, because the activities of the collective bargaining organization were limited to negotiating a price satisfactory to its members. The organization described in Rev. Rul. 76-399 was not engaged in any other activities that fostered or assisted the members in their sales of crops. Moreover, it was neither responsible for entering into any sales contracts, nor obligated to perform the acts necessary to consummate the crop sales. If such an organization were to engage in more than mere collective bargaining, and instead serve to assist its members in collecting, weighing, sorting, grading and shipping agricultural products as a part of a collective bargaining program it would not qualify for exemption under section 501(c)(5). (Rev. Rul. 77-153, 1977-1 C.B. 147.) In short, any agricultural or horticultural organization that provides direct services to its members as one of its principal activities will lose its qualification for exemption, because such commercial services in and of themselves do not better farmers' working conditions, improve the grade of agricultural products, or develop a higher degree of operating efficiency. Additionally, if any exempt section 501(c)(5) agricultural organization engages in marketing products or livestock as one of its minor activities, all income from such marketing activities is subject to unrelated business income tax. (Rev. Rul. 69-51, 1969-1 C.B. 159.)

H.R. 3362 would amend section 501(c)(5) to permit any tax-exempt agricultural or horticultural organization to engage in collective bargaining for the sale of unprocessed agricultural or horticultural products of its members, provided that the organization engages in significant marketing activities solely "as agent to its members" and only as necessary to carry out its collective bargaining activities. This bill is intended to benefit principally the National Farmers Organization, an agricultural organization that lost its tax exemption in 1975 because it was engaged in substantial marketing activities. The proponents of the bill contend that it will merely "clarify" the tax-exempt status of organizations which engage in collective bargaining for the sale of farm products.

The Treasury Department opposes H.R. 3362 for several reasons. First, insofar as it merely "clarifies" the ability of tax-exempt agricultural and horticultural organizations to engage in collective bargaining activities, it is unnecessary legislation, since these organizations have been permitted to

engage in such activities since 1976 under authority of Rev. Rul. 76-399. More importantly, H.R. 3362 reverses the longstanding rule prohibiting any section 501(c)(5) organization from engaging in marketing as a principal activity. This rule was adopted in recognition of the fact that section 501(c)(5) was not intended to grant tax-exempt status to organizations that go beyond collective bargaining by conducting active marketing businesses. Thus, under current law, any agricultural or horticultural organization that wishes to engage to a significant extent in marketing members' products must attempt to qualify as a farmers' cooperative, subject to the special rules of section 521 and Subchapter T of the Internal Revenue Code. Any insignificant involvement in marketing activities by a tax exempt section 501(c)(5) organization is treated as an unrelated business and the income from such insignificant activities is subject to the unrelated business income tax.

H.R. 3362's attempted reversal of this historic prohibition on marketing by agricultural organizations would have immediate and long-range impacts which Treasury finds both objectionable and expensive. Initially, by classifying marketing as a permissable exempt activity, the bill repeals the current unrelated business income tax on all sideline marketing activities conducted by tax-exempt agricultural and horticultural organizations, at a revenue cost of approximately $2 million per year. Further, if section 501(c)(5) organizations are permitted to engage in marketing activities free of any tax on net income, all agricultural cooperatives taxed under Subchapter T will immediately be placed at a considerable competitive disadvantage. Over the long run, many marketing cooperatives described in section 521 would rearrange their business activities in order to qualify for tax exemption under section 501(c)(5), thereby avoiding the existing Subchapter T tax. They could, for example, discontinue taking title to marketed goods or storage facilities and claim that all sales proceeds were received by them solely as agent for their members. Once exempted under section 501(c)(5), these marketing cooperatives could retain a higher percentage of earnings currently paid out as patronage dividends, and yet not pay any tax on retained earnings or on interest accumulations. The potential revenue loss resulting from such a shift to tax-exempt status by existing marketing cooperatives is estimated to be as much as $100 million annually.

Finally, even if this bill were somehow narrowed to cover only the National Farmers Organization, Treasury would still oppose it on grounds that no agricultural organization should be singled out for better treatment than all other tax-exempt agricultural and horticultural organizations and farmers' cooperatives. If the National Farmers Organization

or any other agricultural or horticultural organization wishes to market the products of its members, it should either operate as a taxable not-for-profit membership organization (which is the NFO's current status) or convert to a farmers' cooperative which markets farm products and turns back the proceeds to its patrons. No agricultural organization should be totally exempt from tax on income from its marketing activities.

The Office of Management and Budget advises that there is no objection to the presentation of this report from the standpoint of the Administration's program.

Sincerely,

DAVID G. GLICKMAN

David G. Glickman
Deputy Assistant Secretary
(Tax Policy)

The Honorable
Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

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97TH CONGRESS
1ST SESSION

H. R. 3362

To amend the Internal Revenue Code of 1954 to clarify the tax-exempt status of agricultural and horticultural organizations operated for the purpose of bargaining collectively for the sale of members' products.

IN THE HOUSE OF REPRESENTATIVES

APRIL 30, 1981

Mr. JENKINS (for himself, Mr. SMITH of Iowa, and Mr. FRENZEL) introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 to clarify the tax-exempt status of agricultural and horticultural organizations operated for the purpose of bargaining collectively for the sale of members' products.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. EXEMPT ORGANIZATIONS.

Section 501(c)(5) of the Internal Revenue Code of 1954 is amended to read as follows:

"(5) Labor, agricultural, and horticultural organizations, including such organizations operated for the

purpose of bargaining collectively for the sale of unprocessed agricultural or horticultural products of members: *Provided, however,* That any agricultural or horticultural organization engaged in such collective bargaining provide significant marketing or other similar assistance solely as agent to its members and only to the extent necessary to carry out its collective bargaining activities."

SEC. 2. EFFECTIVE DATE.

The amendment made by section 1 shall be effective for taxable years of any organization beginning after December 31, 1981.

ROBERT DOLE, KANS., CHAIRMAN
BOB PACKWOOD, OREG.
WILLIAM V. ROTH, JR., DEL.
JOHN C. DANFORTH, MO.
JOHN H. CHAFEE, R.I.
JOHN HEINZ, PA.
MALCOLM WALLOP, WYO.
DAVID DURENBERGER, MINN.
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RUSSELL B. LONG, LA.
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DANIEL PATRICK MOYNIHAN, N.Y.
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DAVID L. BOREN, OKLA.
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GEORGE J. MITCHELL, MAINE
DAVID PRYOR, ARK.

ROBERT E. LIGHTHIZER, CHIEF COUNSEL
MICHAEL STERN, MINORITY STAFF DIRECTOR

United States Senate
COMMITTEE ON FINANCE
WASHINGTON, D.C. 20510

February 22, 1983

The Honorable Roscoe L. Egger, Jr.
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Egger:

The Congress will soon be considering legislation to remedy a number of tax problems that may unfortunately discourage many farmers from participating in the Agriculture Department's Payment-In-Kind (PIK) program. Several bills have been introduced in both the Senate and the House which are intended to treat the recipient of a PIK crop payment as if he had actually grown the crop, for purposes of Federal income and estate taxes.

It is our understanding that the income tax issues addressed by these bills (including whether income must be recognized immediately upon receipt of a PIK payment, and a number of technical issues pertaining to the marketing of PIK payments by cooperatives) cannot easily be resolved without legislation. In our view, however, the estate tax issues, pertaining to whether a farmer's participation in the PIK program will disqualify him from the special estate tax valuation and payment rules of Code sections 6166 and 2032A, could be resolved administratively by issuance of an IRS ruling interpreting those provisions.

The special use estate tax valuation rules of section 2032A, and the delayed estate tax payment rules of section 6166, were intended by Congress to prevent the generally applicable estate tax rules from forcing the liquidation of family farms and other closely held businesses solely to pay estate taxes. In the case of a farm, these provisions generally require as a condition of eligibility that taxpayers be actively engaged in the business of farming.

In our view, it would be consistent with the legislative intent underlying sections 2032A and 6166 for the IRS to view participation in the PIK program as qualifying the participant for all of the benefits accorded to farmers engaged in actively growing crops under these provisions. Issuance of such a ruling would not only reflect sound tax policy, but would also be of invaluable assistance to the Administration's efforts to encourage participation in the PIK program.

As you may know, because of the March 11, 1983 deadline for farmers to sign up for the PIK program, time is of the essence in

our efforts to resolve the tax problems associated with this program. Accordingly, we would strongly urge you to issue a ruling at the earliest possible time, clarifying that PIK participation will be treated as if the participant had actually grown the crops received through the PIK program, for purposes of the Federal estate tax. If it is not possible to issue a ruling expeditiously, we would strongly urge you to issue a press release announcing that a favorable ruling on this issue will be forthcoming. Ideally, such a ruling or press release would be issued by March 1, 1983, in order to allow time for farmers to learn of it.

We appreciate very much your attention to this tax matter of critical importance to the American farmer.

Sincerely,

BOB DOLE
Chairman

BD:dsa

cc: The Honorable John E. Chapoton